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THE ROLE OF BANKRUPTCY REFORM IN ADDRESSING TOO BIG TO FAIL

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BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER
PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ROLE OF BANKRUPTCY REFORM IN ADDRESSING TOO BIG TO FAIL

JULY 29, 2015

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C O N T E N T S

WEDNESDAY, JULY 29, 2015

WITNESSES

Additional Material Supplied for the Record

THE ROLE OF BANKRUPTCY REFORM IN ADDRESSING TOO BIG TO FAIL

WEDNESDAY, JULY 29, 2015

U.S. SENATE, SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Patrick J. Toomey, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN PATRICK J. TOOMEY

Chairman TOOMEY. The Committee will come to order.

Good morning, everyone. I want to start by thanking my Ranking Member, Senator Merkley, for joining us this morning in addressing a very important topic. I especially want to thank the witnesses for taking the time to be here this morning, but also for the very, very thoughtful and considerable effort that was put into really very comprehensive and very interesting testimony. So, thank you for submitting that. Thanks for being here this morning.

I need to explain a little interruption that we are going to have in this hearing this morning. We have votes scheduled on the Senate floor at 10, two votes, it is my understanding. So, Senator Merkley and I have agreed that the best way to handle this would be for Senator Merkley and I to give our opening statements and then we will recess for the votes. We will come back as quickly as we can. Hopefully, the Members of the Committee will be able to vote quickly on that second vote and return, and then we will welcome the testimony from the witnesses. So, with that understood, I will proceed with my opening statement and then I will recognize Senator Merkley.

About 5 years ago, President Obama signed into law the Dodd-Frank Act, and he said at the time that, quote, "There will be new rules to make clear that no firm is somehow protected because it is too big to fail." Unfortunately, in my view, the Dodd-Frank Act did not end too big to fail. In fact, it enshrined it in law.

In 2008, taxpayers were forced to pump certainly hundreds of billions of dollars in bailouts to floundering financial institutions. In response, in my view, rather than eliminating taxpayer bailouts, the Dodd-Frank legislation created an orderly liquidation authority which contains an explicit and limitless ability to draw on taxpayer resources.

Let me be clear, I opposed the 2008 Wall Street bailouts then. I oppose them today. And, I do not want to see any bailouts in the future.

But, Dodd-Frank created an explicit bailout mechanism and it appears that the attempt to avoid using that is through massive regulation. We have a number of problems with this approach.

First, the SIFI designation itself, in my view, confers this too-big-to-fail status, and the over-regulation that then is the attempt to avoid the bailout risks turning the financial sector into, essentially, public utilities. The regulations impose huge costs, both directly in terms of compliance costs and a diversion of resources, and the indirect costs that come when overly regulated firms are unable to lend as much as they otherwise would, unable to innovate as much as they otherwise would.

And, I think we should remember that regulators are neither omniscient nor perfect. An institution is likely to eventually fail despite the regulators' best efforts. They simply will not see it coming. And, in fact, I think a persuasive argument has been made that the regulations could even increase the likelihood of failures by correlating risks.

Now, Dodd-Frank deals with the possibility of a SIFI failure through the orderly liquidation authority, and I think there are many serious problems with this mechanism. One is regulators have an almost limitless discretion to force the liquidation.

Second, there is really, under the legislation, there is no opportunity for a restructuring, which should be an option available to a failing institution.

Three, the FDIC is essentially designated to control the bridge entity that is created in the orderly liquidation authority, and I do not know that anyone really believes that the FDIC has the expertise to run a Lehman Brothers, for instance.

The FDIC has unlimited discretion in how to treat comparably situated creditors, and I think that is completely inconsistent with every principle of bankruptcy. It is blatantly unfair. Some creditors could be favored relative to others who are similarly situated. I think you could argue that failure of a financial institution becomes, in fact, more likely because this discretion in the hands of the FDIC might cause a reasonable fear and suspicion on the part of some creditors that they might end up being on the short end of the stick in a resolution, and so they have an incentive to pull their lines of credit at the first sign of trouble.

And, as I said earlier, the orderly liquidation authority explicitly contemplates a taxpayer bailout. It creates the orderly liquidation fund and the Congressional Budget Office has scored the cost of this fund as a little over $20 billion over the next 10 years. That is their quantification of the risk the taxpayers will have to step in and fund this.

So, Senator Cornyn and I, and I want to thank Senator Crapo, who I believe is a cosponsor of the legislation, we have introduced the Taxpayer Protection and Responsible Resolution Act that addresses this too big to fail and this bailout risk head-on. It repeals what I think is a dangerous and subjective orderly liquidation authority. It explicitly forbids taxpayer bailouts of failing institutions. And it replaces the orderly liquidation authority with a trans-

parent, objective, and rule-based bankruptcy process by reforming the Bankruptcy Code so that it is able to handle the resolution of a large, complex institution.

The reforms that we make in our legislation makes the Title I resolution of Dodd-Frank, I think, more credible. In my view, Title I of the Dodd-Frank Act is not inherently a bad idea, since an institution should go through some resolution planning. But, it has to be realistic, and that requires a Bankruptcy Code that can handle it.

I think bankruptcy is superior to the orderly liquidation authority because creditors and shareholders should shoulder the losses if a financial institution fails, not taxpayers. Bankruptcy is transparent. It is a rule based process. And, it minimizes the risk of a creditor run in times of uncertainty. It is superior to OLA, also, because it maximizes the value of an estate by allowing either liquidation or a reorganization. And, as we have contemplated the change in bankruptcy, it would allow for a bridge bank to ensure that you would not have systemic risks in the event of such a failure.

So, today, we are fortunate we will be hearing from some of the world's leading experts on this question of how best to resolve a large, complex financial firm. Again, I want to thank the many experts who have helped with input on this legislation, the experts who are here today as witnesses. I look forward to their testimony and the question and answer period at the end.

At this time, I will recognize Senator Merkley for his opening statement.

STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chairman, and I also thank the witnesses for bringing their expertise and perspectives to bear on this issue, the role of bankruptcy and the issue of too big to fail.

I will be particularly interested to hear what the testimony is in regard to the proposal that Senator Toomey and Senator Cornyn have put together and how effective the Bankruptcy Code would be in resolving large and complex financial institutions without the orderly liquidation authority granted to regulators in Title II of the Wall Street Reform bill.

While reforming the Bankruptcy Code may prove to be useful, I am not sure that bankruptcy alone will be enough to successfully resolve the complex, interconnected financial institutions without disrupting financial stability and the global economy, and certainly that was the purpose of Title II, which was put together on a bipartisan basis with a major role by Senators Corker and Warner.

And, of course, the interesting conundrum here is that the whole goal is to end too big to fail, and as Senator Toomey has presented, that is also his goal and bringing a different perspective to bear, and so your insights will be very beneficial.

In 2008, before Wall Street Reform and Title II, Lehman Brothers filed for bankruptcy. Here we are in 2015 and they are still in bankruptcy proceedings and they are struggling through the complexities of a large interconnected investment bank, and their demise did, indeed, have an impact on the broader economy. So, it is

just a small lens on the challenge that Title II was seeking to address.

So, as we wrestle with this, we here as policymakers do not spend our entire life on a single topic. You all bring intense expertise to bear, and I welcome hearing those insights.

Thank you very much.

Chairman TOOMEY. Thank you, Senator Merkley.

The vote has been called, so at this time, the Subcommittee will recess and we will resume our work as soon as we are able to get back from the votes.

[Recess.]

Chairman TOOMEY. The Committee will come to order.

Again, my apologies for this delay. Senator Merkley is on his way back, but he has indicated that we should get started, and given the patience that our witnesses have already exhibited, I would like to do that.

So, let me first extend a warm welcome to our panel of distinguished witnesses. Mr. Randall Guynn is a partner at Davis Polk & Wardell, LLP; Professor John B. Taylor from the Hoover Institution Senior Fellow in Economics at Stanford University; Professor Thomas H. Jackson, President Emeritus, University of Rochester; and Professor Simon Johnson, the Ronald A. Kurtz Professor of Entrepreneurship at MIT Sloan School of Management.

Each of you will be recognized for 5 minutes to give an oral summary of your testimony. Your full written testimony will appear in the record.

Mr. Guynn, please proceed.

STATEMENT OF RANDALL D. GUYNN, PARTNER, DAVIS POLK & WARDELL, LLP

Mr. GUYNN. Chairman Toomey, Ranking Member Merkley, and Members of the Subcommittee, thank you for the opportunity to testify at this important hearing.

During the past few years, I have spent a significant portion of my time working on resolution plans for a number of U.S. and foreign banking organizations under Title I of the Dodd-Frank Act. I believe that virtually all of the most systemically important banking groups in the U.S. with global operations, known as U.S. G–SIBs, are now safe to fail under the single point of entry recapitalization strategy known as SPoE, for single point of entry.

I have included a step-by-step illustration of SPoE in my written statement. Essentially, it means that only the top tier parent of a U.S. banking group is placed into a Title II receivership or a bankruptcy proceeding. The operating subsidiaries remain open and operating and their losses are effectively pushed up to the parent.

The SPoE strategy was invented by the FDIC under Title II, but my colleagues and I quickly realized that it could work under the existing Bankruptcy Code if three conditions were met. First, the top tier parent must have enough usable TLAC, which is defined as the sum of the parent's regulatory capital and long-term unsecured debt. To be usable, however, the parent's TLAC must be structured so that it is legally subordinate to the group's short-term debt. The purpose of this structuring is so that all the group's losses can be imposed on its TLAC investors before any losses are

imposed on its short-term debt. This will allow losses to be imposed on the private sector without causing the deposits and other short-term debt to run, which is what can threaten financial stability and result in bailouts.

I understand that all six of the U.S. G–SIBs that relied on the SPoE strategy in their 2015 resolution plans now have, on average, usable TLAC equal to 25 percent of their risk-weighted assets, which is five times the amount of usable TLAC they had on the eve of the 2008 financial crisis, as shown in Exhibit F of my written testimony. This should be enough usable TLAC to recapitalize all of them at full Basel III capital levels if they fail under conditions twice as severe as the 2008 financial crisis.

Second, the group must have access to a secured liquidity facility, such as the Fed's discount window, or enough liquidity on its balance sheet to self-insure against liquidity risk throughout the SPoE process. I understand that all six of the U.S. G–SIBs that relied on SPoE in their 2015 plans now have enough liquidity on their balance sheets to execute SPoE in a severely adverse economic scenario without accessing Government liquidity support. Indeed, they have been forced to be so liquid that it is substantially reducing the amount of credit they can supply to the market.

Third, the group must eliminate most cross-defaults in its derivative contracts that would allow counterparties to drain liquidity out of the group the way they did in Lehman based on the parent's bankruptcy when the rest of the group is still open and operating and performing on those contracts. Most of the U.S. G–SIBs have agreed to adhere to a new international agreement called the ISDA Protocol. Under that protocol, 18 of the largest counterparties have agreed to waive their cross-defaults in their ISDA contracts with each other. While the regulators are in the process of expanding the ISDA protocol to cover a wider range of financial contracts and counterparties, the Federal Reserve has characterized the ISDA Protocol as a major accomplishment in making the U.S. G–SIBs safe to fail.

As you know, Title II of Dodd-Frank can only be lawfully invoked if the Bankruptcy Code is not up to the task of resolving an institution. While I believe that SPoE can be done under the existing Bankruptcy Code, I think there is room for improvement. I believe that even the FDIC would agree that we should try to improve the Bankruptcy Code so that the circumstances that allow Title II to be lawfully invoked are reduced to the bare minimum. In my view, a sufficient reason for doing so is that the Bankruptcy Code is more consistent with the rule of law and more predictable than Title II. Adding a new Chapter 14 to the Bankruptcy Code along the lines of the proposed Taxpayer Protection and Responsible Resolution Act should achieve that goal.

I welcome any questions that any Members of the Subcommittee might have. Thank you.

Chairman TOOMEY. Thank you, Mr. Guynn.

Professor Taylor, please proceed.

STATEMENT OF JOHN B. TAYLOR, HOOVER INSTITUTION SENIOR FELLOW IN ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Chairman Toomey, Ranking Member Merkley, for inviting me to testify here.

I think bankruptcy reform is essential to addressing the problem of too big to fail. A reform that handles large financial firms and makes failure feasible under clear rules without spillovers would greatly reduce the probability of Government bailouts.

As you know, much work has been devoted to this issue in the last few years, and I think good reform bills have been introduced, including the Taxpayer Protection and Responsible Resolution Act, but also the Financial Institutions Bankruptcy Act of 2015 in the House.

Chapter 11, of course, has many benefits, including its basic reliance on the rule of law. But for large, complex financial institutions, it has shortcomings. The existing bankruptcy process may be too slow. Bankruptcy judges may not have enough financial experience. But perhaps most importantly with Chapter 11, it is difficult to both operate a failing financial institution and stop runs.

To deal with these shortcomings, a new chapter is needed, like Chapter 14 in the Taxpayer Protection and Responsible Resolution Act. Such a reform would use the rule of law and shift priority rules of bankruptcy. However, proceedings would have Article III judges and special masters. And Chapter 14 could operate much faster, ideally over a weekend, and leave operating subsidiaries outside of the bankruptcy entirely.

It would do this, as you know, by moving the original financial firm's operations to a new bridge company that is not in bankruptcy. This bridge company would be recapitalized by leaving behind long-term unsecured debt. The aim, of course, is to let a failing firm go into bankruptcy in a predictable, rules-based manner without spillovers while people continue to use its financial services, just as people flew on American Airlines planes, bought Kmart sundries, and tried on Hartmarx suits during the bankruptcies of those companies.

To understand how this would work in practice to resolve a large financial institution, our research at the Hoover Institution at Stanford has looked into how it would have worked in the case of Lehman Brothers in 2008, and work by Emily Kapur, a summary of which I have attached to my testimony, is very illustrative for getting a sense of how this new proposal would work in practice.

In my views, Chapter 14 would work much better than Title II of Dodd-Frank. In the case of Title II, the FDIC would have to exercise considerable discretion, and I think in some cases the uncertainty might be so severe that it will lead policymakers to large bailouts anyway. Even if the Title II process were used, bailouts would be likely, as the FDIC might wish to hold some creditors harmless in order to prevent spillovers. The perverse effects of these kinds of bailouts occur whether or not the extra payment comes from the Treasury, financed by taxpayers, or from a fund, financed by financial institutions, or even from smaller payments to other creditors.

Moreover, under Title II, the FDIC and its bridge bank would make the decisions. In contrast, under bankruptcy reorganization,

private parties motivated and incentivized by profit and loss considerations would make the key decisions about the direction of the firm, of course, perhaps, subject to Bankruptcy Court oversight.

I think another advantage of Chapter 14 reform is that it would facilitate greatly the resolution process now under Dodd-Frank. As you know, those resolution plans submitted by the large financial firms have been rejected by the Fed and the FDIC, but with Chapter 14, I think they would be feasible and have a much better chance of passing the law.

So, in sum, Mr. Chairman, Mr. Ranking Member Merkley, I think reform of the bankruptcy law is essential for ending Government bailouts. If it is accompanied by an increase in capital and capital structured debt, such a reform would go a long way to ending the too-big-to-fail problem.

Thank you very much.

Chairman TOOMEY. Thank you, Professor Taylor.

Professor Jackson, please proceed.

STATEMENT OF THOMAS H. JACKSON, PRESIDENT EMERITUS, UNIVERSITY OF ROCHESTER

Mr. JACKSON. Good morning, Chairman Toomey, Ranking Member Merkley, and other Members of the Subcommittee. It is an honor to have the opportunity to testify before you on a subject near and dear to my heart, the title, "The Role of Bankruptcy Reform in Addressing Too Big to Fail".

Specifically, I would like to focus my comments on the role bankruptcy law can and should play in the best possible resolution of a troubled financial institution and how modest but important amendments to the Bankruptcy Code can facilitate that outcome.

First, what do I mean by the best possible resolution of a troubled financial institution? I mean a resolution process that meets four important tests. First, one that both minimizes losses and places them on appropriate pre-identified parties. Second, one that minimizes systemic consequences. Third, one that does not result in a Government bailout. And, fourth, one that is predictable in a sense of conforming to the rule of law in the myriad decisions that are made.

The central role envisioned for bankruptcy law in Dodd-Frank is reflected in two places. First, it is embodied in the notion of resolution plans or living wills. Under Title I, they are specifically to be focused on and tested against a bankruptcy resolution process.

Second, it is also reflected in the statutory requirements for implementing an administrative resolution proceeding, the orderly liquidation authority under Title II. Such a resolution proceeding cannot be commenced without a finding that the use of bankruptcy law would have a serious adverse effect on U.S. financial stability.

But, I think there is a disconnect between these premises and today's Bankruptcy Code. There is an emerging consensus that the best resolution system, one that meets the first three standards I noted above, involves a debt-based loss-bearing capacity known in advance that can be jettisoned in a rapid recapitalization of a financial institution. In the U.S., this system is represented by the FDIC's single point of entry proposal for the recapitalization of a financial institution holding company.

But, even with required loss-bearing capacity, when compared to the FDIC's current proposal, the current Bankruptcy Code, in my view, is what we would say, close but no cigar. Yes, Chapter 11 of the Bankruptcy Code is increasingly used to effectuate a going concern sale of a business, sometimes rapidly through a prepackaged plan, but it will struggle to do this in the case of a financial institution.

The essence of a recapitalization is leaving behind equity and the loss-bearing debt to bear the losses and the transfer of everything else—assets, liabilities, rights, licenses, and subsidiaries—to a bridge company that, because of the stripping off of the loss-bearing debt, is presumably both solvent and in a position to deal with the needs of its subsidiaries, and this must be done with great speed so as to restore market confidence without a contagion-producing run.

The current Bankruptcy Code, I believe, cannot provide the necessary assurance of a rapid recapitalization of this sort. Even with the announcement of a new protocol by the International Swaps and Derivatives Association that ends the ability to immediately terminate qualified financial contracts in a resolution proceeding, the problem remains, it currently only applies to the 18 largest global financial institutions and it does not deal with change of control provisions and licenses or other nonexecutory contracts.

Nor is it certain to me that a judge under the current Bankruptcy Code would feel comfortable even with a resolution plan authorizing the transfer and, hence, recapitalization in a period such as 48 hours without clear statutory authorization. This will lead, in my view, either to ineffective resolution plans and/or the reality that OLA under Title II will, contrary to expressed desires, become the default resolution mechanism.

What is required in addition to specified debt-based loss absorbency capacity known in advance that is being addressed separately, it requires explicit statutory authorization for a rapid 48-hour transfer of a holding company's assets, liabilities, rights, and subsidiaries minus loss-absorbing debt and equity to a bridge institution and stays and overrides of provisions to allow that to happen.

The Taxpayer Protection and Responsible Resolution Act provides the core changes to the Bankruptcy Code to make it a credible resolution mechanism, as does the House bill enacted last session. Both neatly provide the necessary amendments to bankruptcy law to permit this rapid recapitalization. Think of it as taking the structure that is there of the going concern's sale under Section 363 of the Bankruptcy Code and putting it on the necessary steroids to deal with a large financial institution.

While there can be robust debates on several choices made, as I illustrate in my written statement, these minor disagreements should, in my view, not hold back the consideration or enactment of these bankruptcy provisions, nor should non-bankruptcy-related considerations. We need these amendments to the Bankruptcy Code.

And, again, I would like to thank the Subcommittee for allowing me this opportunity to express my views. And, of course, I would be delighted to take questions.

Chairman TOOMEY. Thank you, Professor Jackson.

Professor Johnson.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you, Senator, and thank you for holding a hearing on such an important and timely topic.

I would like to make three points. First, I think all companies in the United States should be able to go bankrupt. I think you could regard it as a right of American corporations. I do not understand why some companies should have access to a different Bankruptcy Code than other companies. If you are going to change the code, and I am completely open to that, I think it should be available to all companies on an absolutely equal footing.

If we start to say some companies have different access, some companies can get different kinds of protection from their creditors, surely, we open again the question of is that better or worse, and if it is better, if I am getting some additional protection from my creditors, do I not want to be in that category, and you have just created a version of "too big to something" that you said you were trying to avoid.

The essence of the various bankruptcy proposals that we have before us in the public debate, all of which are, obviously, very well thought through and extremely detailed, I think it really comes down to this, Senator, which is are we providing debtor-in-possession financing from the public sector in some form to a bankruptcy court or not? If we are not, then the private sector has to provide the funding, which they will not. That is why it is called a crisis. The idea that we can rely on these companies to always have enough liquidity on their balance sheet to avoid this issue, I think, is unrealistic. Again, that is why it is a crisis, because they run out of liquidity.

Now, if the Government is providing debtor-in-possession financing, that is a different ballgame altogether. But, I have a lot of concerns about that, Senators, as I think you must. So, if, let us say, we come to a point where the Treasury—it would be the Treasury, not the Fed, I believe—is providing a loan of $10, $20, $50 billion to a bankruptcy court, what is the political legitimacy of that? What is the economic expertise and management skills being brought to bear on that by the bankruptcy judge or whatever trustees they put into place? I think the backlash, justifiable backlash you would get against that would be enormous, and I really do not think that is a good idea from the economic point of view.

Now, if we agree that some large financial firms would have trouble going bankrupt, or if they went bankruptcy under the current code we would risk re-running a version of the Lehman scenario, I think there are actually two routes forward. One is to try and change the code selectively for those firms, and I am very worried about that. The other is to change the firms, and as I think we agree—certainly the witnesses seem to be agreeing—under Dodd-Frank, the presumption is that all firms would be able to go bankruptcy and Title II is there as a backup, last resort, just in case the regulators got it wrong in the living will planning process and find at the very last moment, as they did in the Lehman week-

end, for example, after the Barclays deal fell apart, they find that the consequences, or they begin to think the consequence of that bankruptcy could be cataclysmic for the system.

Now, where, exactly, is the pressure point going to be and how does it compare with current structures? I think it is pretty obvious, and again, we saw it in the Lehman case. It is global. It is cross-border.

For example, the FDIC—and I think the living wills process and the resolution planning process has been helpful. It has revealed a lot of details that are very useful, including the following. The FDIC has a Memorandum of Understanding with the Bank of England on how they would cooperate in the event of resolution. That cooperation would not apply if we were following Title I bankruptcy.

The global nature of these firms really matters. If Lehman or any other firm today were put into bankruptcy, the U.K. and other regulators around the world would immediately move to seize assets, just as they did in September 2008. Now, that is extremely not helpful. You are not going to change that by amending the U.S. Bankruptcy Code. You would need a treaty between countries to cooperate in the event of bankruptcy, and I really do not think you are going to get a treaty. You need to change the global nature of these businesses and/or make them considerably smaller, firewall them off international.

The TLAC, the total loss absorbing capacity that we have started to talk about, is a complete illusion, Senator. There is no such thing as loss absorbing debt. When the debt goes down, you find the person who was holding that contingent debt did not fully understand the risk. You find they were highly leveraged. You find they were an insurance company. You find they were an AIG. You find that they were held by money market funds. It is September 2008. Again, you need equity. You need a lot of loss absorbing equity on the balance sheet at the holding company level of all these global companies.

We have inched toward reasonable equity levels measured on that basis. We have not made much progress. The amount of equity on the balance sheet of our largest banks is between 4 and 5 percent measured on a leverage basis. That means 95 to 96 percent debt, 4 to 5 percent equity. And they gamble massively in the global markets every day. That is the point on which we should be focusing, and that is how you address the bankruptcy issues, as well.

Thank you.

Chairman TOOMEY. Thank you, Professor Johnson.

Well, let me just start—let me just follow up on this, and maybe this will give an opportunity for Mr. Guynn to respond to something that Mr. Johnson said, because, Mr. Guynn, you indicated in your testimony that one of the essential features of having a successful resolution of bankruptcy is loss absorbing capital, which intuitively makes sense to me, but Professor Johnson said, among other things, maybe the creditors do not understand the nature of the risk. I find that implausible, frankly, but how would you respond to his concern that TLAC is not adequate?

Mr. GUYNN. Yes. Well, I obviously disagree with Professor Johnson, and I think the FDIC disagrees and so does the National

Bankruptcy Conference. The fact of the matter is that if you convert debt to equity in a bankruptcy proceeding, it is loss absorbing just like equity. There is no difference between the two. And, it does not matter whether you do that through a direct bail-in or a bridge bail-in—what I think Professor Jackson refers to as a one-entity or a two-entity recapitalization. The single point of entry method using a bridge financial company is a two-entity recapitalization, where you basically transfer all of the assets of the failed company to the bridge and you leave behind in a receivership or bankruptcy its long-term debt. The debt gets converted to equity in that new company. So, it is loss absorbing and I do not know why Professor Johnson says otherwise.

Chairman TOOMEY. Let me move on to another issue here, and this is for Professors Taylor and Jackson. Do you think it is fair to say that the nature of the orderly liquidation authority as it exists now, together with the Bankruptcy Code as it exists now, actually could increase the risk of a failure in the event that there were some volatility, disruption, problems in the markets?

Mr. TAYLOR. Well, I think, currently, the first part of Dodd-Frank Title I, where the living wills are submitted and approved, that is not working, and I think the problem is the existing Bankruptcy Code. So, a revision of that would help. I think it is very important for that purpose alone.

I also, as I indicated in my testimony, am concerned about Title II's operations of high degree of discretion given to the FDIC, the uncertainty that might cause, and, therefore, the possibility of additional uncertainty and risk from that. So, I would agree that there is a problem with that, as well.

Chairman TOOMEY. Professor Jackson.

Mr. JACKSON. I am not sure I would think it increases the likelihood of a failure. I think what you would have now——

Chairman TOOMEY. And could I just interrupt for a second——

Mr. JACKSON. Yes.

Chairman TOOMEY. ——just because an increase begs the question of relative to what, and I mean relative to a bankruptcy mechanism that works.

Mr. JACKSON. Yes. I think it does in the following way, or at least it pushes everybody to Title II OLA resolution proceedings, which is expressly contrary to the express desire even in Dodd-Frank for Title II itself, because currently, even with the ISDA Protocol, for most of these financial institutions, Title II stays the derivative contracts for the period necessary to enter the bridge company. A bankruptcy has exemptions from the automatic stay for qualified financial contracts and is unable to do that. So, it is a big mover away from being able to use bankruptcy, and I suspect it is a hang-up on the resolution plans, which need to show what happens under bankruptcy, not under Title II.

Chairman TOOMEY. And, Mr. Guynn, the legislation that I have introduced with Senator Cornyn, the way I think of it, it has got three main changes that it makes to the Bankruptcy Code. One is it creates a panel of experienced judges who would handle the filing of a bankruptcy. The second is it creates these temporary 48-hour stays on derivative instruments in particular, but some oth-

ers. And then, of course, it creates the bridge company, which is similar to what is contemplated in OLA.

In your view, are each of these three items important reforms to bankruptcy, and would you just care to comment on them.

Mr. GUYNN. Sure. I think all three of them are actually very useful reforms. Obviously, having a set of bankruptcy judges or Article III judges who have experience, or view it as their mandate to develop expertise, about financial institution failures is a good thing. It is going to work better.

As far as having a stay for 48 hours, that is a also good idea. Most derivatives contracts are actually booked at the operating subsidiary level, so you tend not to have a termination of those contracts under SPoE unless the contracts contain cross defaults to the parent's failure. There are very few derivatives at the parent level and they tend to be inter-company, so they typically will not be terminated. But, having a 48-hour stay is very useful, and in particular, your bill also would override cross-defaults, which is actually very useful. Otherwise, you have to rely on something like the ISDA Protocol, which I discussed earlier.

The last one—I have forgotten the last thing you mentioned——

Chairman TOOMEY. The bridge company.

Mr. GUYNN. Oh, the bridge company. This is helpful, and also, I think, combined with the express authority to be able to transfer quickly the assets to a bridge. I think that convincing bankruptcy judges they have the authority do a quick transfer to a bridge is probably the biggest challenge under the current Bankruptcy Code. It can be done, we believe it will work, but it will require education of bankruptcy judges themselves to say, yes, you have this authority. The bankruptcy judge did a quick sale in Lehman within 4 days. You are not actually doing a sale here. You are just moving the ongoing operations into a bridge company that will be held for the benefit of the bankruptcy estate. Nevertheless, having the legal authority clearly spelled out in a statute will eliminate the legal uncertainty as to the authority of the judge to do it.

Chairman TOOMEY. Thank you, Mr. Guynn.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman, and thank you all for your presentations.

Professor Taylor, you mentioned that you do not believe the living wills are working, but I just want to check in. In terms of Title I living will, the concept behind it, my impression is that all of you support that work being done, is that correct?

Mr. TAYLOR. Yes, I support that.

Senator MERKLEY. And, Mr. Taylor, or Professor Taylor, are there a couple things that, specifically, you would like to see done to improve the working of those living wills?

Mr. TAYLOR. I think, in particular, if there was a—something like Chapter 14 or something like the proposed bill here, it would make it feasible for the companies to submit the resolution plans, living wills, that are consistent with a bankruptcy without Government bailout. It is now very difficult to do that. The whole idea of having an operation that is in bankruptcy and preventing it from running under existing law is hard, and so they say, well, we need some help. We need some extra support. So, there is that inconsist-

ency. So, Chapter 14, I think, resolves that, because you can operate the institution. Its businesses will still be operating through this bridge company.

Senator MERKLEY. Thank you.

And, Professor Johnson, any insight on that particular piece of the puzzle?

Mr. JOHNSON. Yes, Senator. I think the Dodd-Frank intention is pretty clear and consistent, actually, which is given the existing code, which was not modified as part of Dodd-Frank along this dimension, the banks have to show that they are able to be resolved through bankruptcy without causing large systemic risks, which, I agree, means that most likely they would have to be liquidated or wound down, and the fact that we are having this conversation tells you that many people out there in the business community are very concerned about the systemic implication of such a wind-down, which means, according to the logic of Dodd-Frank, if you are not going to amend it, that the regulators should be moving to make these banks much safer, presumably smaller, presumably simpler, and much easier to unwind through liquidation.

Senator MERKLEY. Thank you.

I want to turn to the orderly liquidation fund, which I think is part of the point that the Chairman is making, concerned that that turns into a taxpayer-funded bailout. I wanted to check in on that point with all of you. The OLF line of credit available through the FDIC was envisioned to enable the FDIC to provide fully secured loans at above-market rates to sufficiently capitalized or recapitalized firms, and thus the lender of last resort facility. And, losses—under that OLF, the losses are imposed on the shareholders, long-term unsecured debt holders, the holders of other liabilities, but not on taxpayers. And, the FDIC would have to proceed to cover those costs either through the assets of the failed company or eventually post hoc assessments on surviving financial institutions.

Now, I believe Mr. Guynn and Professor Jackson, that you all were two of the principal authors of a report that addressed this, and if I understood it correctly, I thought that that made some sense. But, I wanted to ask you all about that now.

Mr. GUYNN. Yes. Thank you. So, the standards that you actually recited are the classic standards that Bagehot set out more than a century ago for central bank lender of last resort liquidity, and the FDIC has announced that it would use the orderly liquidation fund according to those standards. The statute itself does not actually bind them to that. So, that is why, to the extent people sometimes criticize the OLF, it is because those standards are not embedded in the statute. But, the FDIC has said that that is how it would use the OLF, and so that is the appropriate way to use it.

Senator MERKLEY. So, with that caveat, it makes sense to you?

Mr. GUYNN. Yes.

Senator MERKLEY. OK. And Professor Jackson.

Mr. JACKSON. Yes. I think that one of the great advantages of single point of entry, either under Title II or under the Chapter 14 procedure, is that the bridge institution—and I think it works better in bankruptcy because it is not under the supervision of the FDIC—is a company that is recapitalized, should look immediately

solvent to the market participants, and generally should be able to get its own liquidity in a vast variety of circumstances.

There may be some, such as a liquidity freeze across institutions, a little bit like happened in 2008, 2009, where that will not be possible, and in those cases, it seems to me, and now speaking about bankruptcy specifically, the Federal Reserve Board's ability to lend to institutions where there has been a multiple industry problem strikes me as a solid back-up that would not need to be changed.

Senator MERKLEY. Thank you.

Professor Johnson.

Mr. JOHNSON. Senator, I used to be the Chief Economist at the International Monetary Fund and I worked on a lot of crises over the past 30 years. There is never liquidity in the market. That is why it is a crisis. And, the financing terms of this fund would be absolutely critical.

I do agree that the FDIC has drawn up some sensible rules. I do not think that this bankruptcy scenario would work at all in terms of avoiding systemic risk unless there is some sort of additional Government-provided financing, and I do not think you want to provide that kind of Government financing to a bankruptcy corp.

Senator MERKLEY. Thank you.

Chairman TOOMEY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. I apologize for being late. We are trying to cover three hearings at the same time.

So, let us get to the key point we are talking about here. No financial institution should be too big to fail, and to me, that means three things. If a bank is on the verge of failure, we should be capable of shutting it down without bringing down the entire financial system. The shutdown should not require a dime of taxpayer money. And the shutdown should not create moral hazard by letting the bank's executives escape accountability.

Now, the Chairman recently introduced a bill that creates a new process for liquidating our biggest financial institutions and repeals the existing process found in Title II of Dodd-Frank, and I appreciate the Chairman's efforts, but I am concerned that his proposal creates more problems with each of the three standards that I just laid out.

The Chairman's bill does not create any established source of short-term liquidity, the point we were just talking about here, for any failing institution, instead relying on the market to provide funding for that failing institution.

So, just so we have got the record clear on this, Professor Johnson, let me ask you, is it realistic to expect the market to provide short-term liquidity for a failing institution in a time of crisis?

Mr. JOHNSON. No, that would not be a realistic expectation.

Senator WARREN. All right. And, in fact, I thought I heard you say, Professor Jackson, the answer is, let the Fed bail them out if it is a short-term liquidity crisis.

Mr. JACKSON. No. My—the failed institution—one of the great advantages, I think, of the bridge company is it immediately transfers a failed institution into two different entities, an entity that has——

Senator WARREN. I understand that——

Mr. JACKSON. OK.

Senator WARREN. ——Professor Jackson. I understand how this works. I just listened to your testimony just now and you said, gee, if we had a crisis like 2008 and liquidity dried up, as Professor Johnson said it most likely will in this kind of circumstances——

Mr. JACKSON. But it would be under——

Senator WARREN. ——it would say, let the Fed take care of it.

Mr. JACKSON. It would be under the circumstances where it was not directed at the particular institution but to a broader liquidity problem.

Senator WARREN. But——

Mr. JACKSON. And, I——

Senator WARREN. But you are talking about putting taxpayer dollars in, and to me, that is what too big to fail is all about.

Mr. JACKSON. Taxpayer dollars into an industrywide issue that would not distinguish between the institution that was in the resolution proceedings and the ones that were not.

Senator WARREN. So, in other words—let me just wrap this back around. Professor Johnson, would not the Chairman's bill just put us back where we were in the 2008 crisis so that Congress would either have to step up with a taxpayer bailout or risk the entire meltdown of the financial services industry and potentially the economy?

Mr. JOHNSON. Yes. I fear you would have another Hank Paulson–Ben Bernanke moment when they come to you and say, if you do not give us a large amount of money with few strings, there will be a global cataclysm.

Senator WARREN. Well, and I think that is what we are all trying to avoid here.

You know, there is one other part to this that I want to talk about, besides the fact that the Government should not be—the taxpayers should not be put in the position of having to choose between either watching the economy implode or having to bail out these big financial institutions, and that is the question of moral hazard built into this.

The Chairman's bill lets the CEO and the management team of the bank keep their jobs and all of their past compensation. That is the same sweet deal that the bankers got in 2008. So, Professor Johnson, let me ask, do you believe that the Chairman's bill does enough to discourage senior management from taking on big risks that threaten the entire financial system?

Mr. JOHNSON. I think, Senator, that it does not do enough. I think that was a major issue in the run-up to 2007 and I fear it could absolutely happen again.

Senator WARREN. All right. Thank you.

I know this is a complicated issue and I appreciate the Chairman's contribution to this conversation, but I have serious concerns about any proposal that would once again force Congress to face another bailout decision and would once again let CEOs get all of the upside of taking big risks but none of the downside on this. I think we need more accountability in the system, not less.

Thank you, Mr. Chairman.

Chairman TOOMEY. Thank you.

So, to begin the second round, let me just ask a question. If a car company or an airline goes into bankruptcy, does the Bank-

ruptcy Code force the senior executives all to be fired as a result of that? Professor Jackson.

Mr. JACKSON. No.

Chairman TOOMEY. No. But, I guess some believe that the financial institution should be uniquely subject to that.

Let me ask this question. Dodd-Frank as written specifically says that the default setting for a resolution should be bankruptcy. Professor Taylor, do you think right now, as a practical matter, the market believes that the default setting for the failure of a big financial institution would be bankruptcy, or——

Mr. TAYLOR. No, I do not believe so, Mr. Chairman. I think that is the purpose of the proposal you have, Chapter 14, whatever you call it. It is to allow that to happen, to have a bankruptcy in a credible way.

Chairman TOOMEY. But, the point is that right now, that is not perceived to be a credible alternative.

Mr. TAYLOR. That is correct.

Chairman TOOMEY. Despite the fact that Dodd-Frank contemplates that that should be the preferred path.

You say in your testimony, Mr. Taylor, that under Title II, it would likely—that the confusion of how a firm would be reorganized would likely lead policymakers to ignore the orderly liquidation authority in the heat of a crisis and resort to massive taxpayer bailouts as in the past. So, as I understand it, you are saying that the current structure that we have very much contemplates, or it would very much resort to this taxpayer bailout. Could you elaborate on that a little bit.

Mr. TAYLOR. Well, that is a real concern with the Title II and the orderly liquidation authority, the resolution process. The FDIC would effectively have discretion about which creditors benefit, which do not. It would not necessarily use the priority scheme of bankruptcy, which is very clear in the law. I think that uncertainty would make people nervous, and a policymaker in a very responsible position would, quite frankly, I think, be tempted to go through a bailout like we saw before in 2008. So, I am concerned about that.

Chairman TOOMEY. And, the last question for Professor Taylor, I think, if I understood the Senator from Massachusetts articulate three concerns about what ought to happen in the event of a failure, one would be the possibility of shutting down the institution, one would be not costing taxpayer money, and the third would be firing the executives. But, then my legislation was criticized for not, I think, for not having the Government providing any financing facility, debtor-in-possession facility, which seems to me to be the exact mechanism that would put taxpayers at risk. Is that your view, Mr. Taylor?

Mr. TAYLOR. Yes. I think the importance of a bankruptcy concept is the people who are holding this debt are the ones that are going to suffer. They are at risk. And, if there is a sufficient amount, and Mr. Guynn indicated, that will resolve this operation. It is important to get a sufficient amount, to be sure. But, they will suffer the losses. That deals with the moral hazard issue. That has a much better sense of risk taking and it does put people at risk if the Government goes through with a proposal like this.

Chairman TOOMEY. So, Mr. Guynn, it seems to me that—one of the things that I have been concerned about for a long time is that regulators have generally, and I am reluctant to paint with too broad a brush here, but I do perceive a sense on the part of many regulators that their job is to make it impossible for a financial institution to fail, which might suggest that they do not have a great deal of confidence in the current resolution mechanism. But, whether or not that is their motivation, is there a danger, in your view, that could result from over-regulation in the attempt by regulators to make it impossible for an institution to fail, and if so, what is the downside of over-regulation?

Mr. GUYNN. Well, obviously, over-regulation can be a drag on the banking system, which will then be a drag on lending and a drag on the broader economy. I actually think that the banks have a lot more liquidity and capital and loss absorbing capacity than they have had before. So, it is very different from 2008. In fact, in my written testimony, I have an exhibit that shows that they actually have five times the amount of cash and high-quality liquid assets now than they had in 2008.

And, I actually think that it is possible for banks to have too much liquidity. In fact, I mean, Governor Tarullo gave a great speech on this subject last November, where he talked about two extremes: banks being required to self-insure against liquidity risk, even in a failure situation under an SPoE, and he also talked about the other extreme, where they are over-reliant on lender of last resort facilities, and suggested that there needed to be a balance between those two.

The fact of the matter is that the banks currently have been forced to become and have become arguably too liquid in order to show that the SPoE resolution strategy under the Bankruptcy Code is credible. So, the real question is whether forcing them to do that is good public policy or not or whether there should be more of a balance.

Chairman TOOMEY. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chairman.

I want to go back to this issue of liquidity at the time of crisis. So, we have a major firm that perhaps they are unable to provide the funds to complete a 24-hour repurchase agreement. There are various other things that are unfolding very quickly. They are in crisis. And, the general understanding was that if you want—you have three possible situations there. They can turn to liquidity to the private markets. They can turn to liquidity in something like the OLF, where it is—liquidity is ultimately funded by both the company assets or an assessment on the banking world. Or, you just proceed with a chaotic collapse.

And, I think the theory was that the chaotic collapse did not work very well in 2008. It created a contagion that spread from company to company. You had a fire sale on one set of assets, Lehman Brothers, that diminished the value of those assets held in the other companies, and it was not a pretty outcome, and that private liquidity is not going to materialize in that situation. They would not be in crisis if they could access private liquidity. So, therefore, turning to a structured liquidity funded by both ultimately the as-

sets of the company and the FDIC assessment would be the most logical result.

And, so, I think at least three of you have supported the idea of the OLF within Title II, but I just wanted to, since this is kind of at the heart of this discussion as to whether this is the most logical path, I just wanted to start and run across, have all four of you comment on this. Professor Johnson.

Mr. JOHNSON. Well, yes, Senator, today, because the living wills process has not been followed through. It is a failure of implementation of Dodd-Frank. Dodd-Frank absolutely requires, and I think that, largely, the discussion shows this, that these banks have to become simpler and much easier to resolve under the existing Bankruptcy Code and we have not done that. So, yes, there is this fallback on the OLA, and I think you are right to be uncomfortable. We should not be jumping straight to Title II. We have not worked through Title I properly.

Senator MERKLEY. OK. So, that taken, we need to do a lot more work to implement Title I. But, at this point, would you support the repeal of Title II, or is that backstop an important one to have?

Mr. JOHNSON. You need to backstop, Senator. But, the regulators have to understand, and I think it is very helpful to have this kind of hearing to make the point to them that it is not satisfactory to just fail to follow through on the intent of Dodd-Frank and to let the large banks off the hook with regard to their resolvability under bankruptcy under the existing Bankruptcy Code. Nobody on this panel is saying that that is feasible, right.

Senator MERKLEY. Right.

Mr. JOHNSON. That is a failure of implementation of Dodd-Frank.

Senator MERKLEY. Very good.

Professor Jackson.

Mr. JACKSON. With respect to the orderly liquidation fund, I think the concept is good. I think it has the potential of being abused. I do not think it needs to be mirrored or replicated in the bankruptcy process where the bridge company is not under FDIC authority, should be recognized as solvent. I do think, and I think it is distinct from a bailout, it should have the same access rights to Fed funds as other institutions do at a time of liquidity——

Senator MERKLEY. But, you are not arguing at this point for a repeal of Title II?

Mr. JACKSON. I actually—I think Title II—I think, one, if you do these bankruptcy reforms, you are going to diminish enormously the need to rely on Title II, which is explicitly part of Dodd-Frank to begin with. That is step one. You will get a lot—without repealing it, you will make it actually a much less likely scenario.

Second, I think the world may unfold in uncertain circumstances, so I would like to see it there as a backup——

Senator MERKLEY. Thank you. Thank you.

Professor Taylor, keep it as a backup or repeal it?

Mr. TAYLOR. Well, I am sorry. With respect to the 2008 situation, there was so much confusion about how each company would be handled, Bear Stearns, Lehman Brothers, AIG. The advantage of having something like this reform of the Bankruptcy Code is it would, in principle, be a uniform treatment for these firms. There is in the law currently a backstop, 13(3) of the Fed. I think it needs

to be implemented in a way that is clear, penalty rate, for example, or the rule of how it would be operated——

Senator MERKLEY. Because I am running out of time, just get to the heart of it. Do you feel that with that additional provision that you referred to that we can eliminate Title II, or would you keep it as a backstop?

Mr. TAYLOR. OK. So, I would really just want to repeat, if you like, Professor Jackson on this. I think whether you have Title II or not, you need this reform.

Senator MERKLEY. OK, that is fine——

Mr. TAYLOR. My preference——

Senator MERKLEY. ——but that is not the question I am asking——

Mr. TAYLOR. ——would be not to have Title II and have this reform. But, whether you have it or not, this reform is essential.

Senator MERKLEY. The Chairman is going to cut me off. That is why I am asking you to be succinct. But, what Professor Jackson said was that changes may make it far less necessary, but you should keep it as a backstop, and you are echoing that sentiment in your concluding sentence there?

Mr. TAYLOR. Actually, I am sorry to take so much time with this, but I have written it. Problems with Title II, I think, is problems as it exists. I would prefer if it goes. However, the reality—if that stays, I would really support so much having the Chapter 14 or whatever this bill is. I think it is very important to make this whole operation work.

Senator MERKLEY. I had so many other questions I was going to try to get to. I am not going to make it, so I will just complete this panel. Mr. Guynn.

Mr. GUYNN. So, I think even the FDIC would support this legislation, making bankruptcy better so that Title II is only needed in the smallest number of circumstances. But, I think it is useful to retain Title II for at least one reason, and that is to preserve cross-border cooperation by foreign regulators. The U.S. is almost unique in having a tradition of reorganization in bankruptcy. Outside the United States, the regulators just do not associate it with bankruptcy. When they hear the word bankruptcy, they think liquidation, and so it is actually useful to have Title II just so they know that there is a backup of something that looks more like their special resolution regimes, which they associate with recapitalization or reorganization. Ironically, we call Title II the orderly liquidation authority. They associate Title II more with reorganization or recapitalization regimes.

Chairman TOOMEY. Thank you.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So, the Chairman asked the question about why deal with moral hazard and suggested that to say that bank executives of these large too-big-to-fail banks, if they bring down an entire institution, should have some responsibility for that. And, so, I just want to ask the question again. When a big construction company fails, he asked the question, are the executives fired under Chapter 11 and the answer is no. But, does a big construction company, if it fails, threaten the entire economy? Professor Johnson.

Mr. JOHNSON. No, hopefully not——

Senator WARREN. Hopefully not, at least——

Mr. JOHNSON. ——not historically.

Senator WARREN. Yes. And, do we see the Secretary of the Treasury or the Federal Reserve Chair coming in to tell the American people that they need to bail out a big construction company?

Mr. JOHNSON. No, we have not experienced that.

Senator WARREN. All right. So, I think—and then the question is, does that change the calculus on whether or not we need to find devices in the law for holding the executives of the biggest financial institutions accountable if they threaten to wreck the economy again. Professor Johnson.

Mr. JOHNSON. I am absolutely in favor of holding them accountable, and just to add a small fact to this, the corporate executives of the top 14 U.S. financial companies made $2.5 billion in compensation between 2000 and 2007. The most compensated five of them made $2 billion of that. They were the people who took on the risks of all the big companies that you know very well, the AIGs, Countrywide, Lehman, Bear Stearns. They are the ones who brought down the system. So, the moral hazard is front and center of our concerns here.

Senator WARREN. All right. Thank you. Thank you, Professor Johnson.

And, I just want to go to one other point, and that is I very much am struck by your point, Professor Taylor, and that is that markets do not believe that, if pressed, the United States Government would not bail out the too-big-to-fail banks right now. I think that was your point, right?

Someone asked a question, the law right now says that we will not. If we pass five laws that say we are never going to bail them out, will that change whether or not the markets believe that, if pressed, if the economic system is at risk, if a too-big-to-fail bank threatens to bring down the entire economy, that what will happen is that the American Government and the American taxpayer will be put on the hook to bail them out?

Mr. TAYLOR. Senator, the purpose of this bill, or Chapter 14——

Senator WARREN. I am not asking you that question.

Mr. TAYLOR. Well, that is how I would answer it.

Senator WARREN. Well, what I heard you say is that no one believes——

Mr. TAYLOR. With the current bankruptcy law.

Senator WARREN. All right. Let me ask it a different way. In 2008, did we have a law that said that the Federal Government would bail out the biggest financial institutions if they threatened to bring down the entire economy?

Mr. TAYLOR. No. We had the——

Senator WARREN. No. We had no law on it, right? And yet, when faced with the choice of either watching the economy collapse or bailing out the biggest financial institutions, what did Congress do at that point?

Mr. TAYLOR. They bailed them out.

Senator WARREN. They bailed out the biggest financial institutions.

The question for me, and this was the one that the Chairman asked—I understand, we are trying to get to the same place. We are not at loggerheads over this part of it. The question is, realistically, how do you get there. And for me, that is why things like the living wills are so important and why they intersect powerfully here. It is why regulatory structure is so important. It is why Glass-Steagall is so important. The things that keep us away from coming to the precipice of banks that can bring down the entire economy.

So, I appreciate the point, and I really do. I am not trying to argue with you about where we are trying to get. It is just a question of whether or not passing one more law to promise, promise, promise we will not bring down the economy will change—will not bail out big banks—will change anything if we are put in the position of it is either bail out the big bank or watch the economy collapse, and that is the part I am worried about.

Mr. Chairman, thank you.

Chairman TOOMEY. Well, and I thank the Senator from Massachusetts and I appreciate her participation and her thoughtfulness on this.

I would just—it seems there is a pretty clear disagreement about one fundamental aspect here. It is my view, and I would like to get the input from our witnesses, that the way in which to ensure that the market does believe that resolution in a bankruptcy is adequate and to ensure that taxpayers are not at risk, Professor Johnson has one approach, which is shrink the banks. It strikes me that one could view that as the tail wagging the dog a little bit, because maybe the cause of the problem is the inadequacies of the Bankruptcy Code. And, so, if we correct the inadequacies of the Bankruptcy Code and we do it in a way that taxpayers are not at risk, then we do not have to bother with deciding exactly which line of business on a Tuesday a given bank can do as we do now.

So, I guess my question for Professor Taylor is, is it your view that if we made these changes to the Bankruptcy Code, which Congress is, of course, entirely free to do if it chose to, that the market would believe that the Bankruptcy Code would work and, therefore, would be used, and, therefore, we would not face this question of must we bail out the banks or face a systemic crisis.

Mr. TAYLOR. Yes. That is really the whole purpose, in my view, is to give—when the policymakers in the future come to Congress and ask for a bailout, you say, there is an alternative. You have this bill, this Chapter 14, which is the way to go through bankruptcy without causing spillovers, without causing this damage. And, so, no, we do not need a bailout. We will not do that. We have this alternative, which is much more credible.

Chairman TOOMEY. Now, Mr. Guynn, I think you said earlier that you think it is entirely possible that the Bankruptcy Code might be adequate as it is currently written, but that it would be much better if it had these changes. If it did have these changes, is it your view that there would be a broad consensus that a failure of a large firm could be safely resolved through bankruptcy?

Mr. GUYNN. Yes. But let me answer that by responding to Senator Warren because I think she was characterizing your Chapter 14 proposal of having a provision that says, "Thou shalt not bail

out banks." The only law that has something in it like that is actually Title II. What is important are not statements saying you will not bail them out, but, rather, frameworks that allow you to set up a mechanism so that, in fact, you can safely impose losses on creditors without creating runs, and that is what your bill actually would do, and that is why it would help.

Although I do believe that one can resolve institutions using the single point of entry strategy under the existing Bankruptcy Code—and that is the key, it is being able to do it under that strategy—it is much better and it will be legally much more certain with your bill being enacted.

And, let me just mention that all the key regulators around the world believe that is actually the single point of entry will avoid bailouts, and if you look at all the regulators in the U.S., you have former FDIC Chairman Sheila Bair saying, "This is a viable strategy." You have Governor Tarullo saying, "best potential for the early resolution of the systemic financial firm." Fed Chairman Janet Yellen, "very promising." Governor Jay Powell, "a classic simplifier making theoretically possible something that seemed impossibly complex." President Dudley of the New York Fed, "very much endorse the FDIC's single point of entry framework." Tom Baxter, General Counsel of the New York Fed, calling single point of entry a "visionary breakthrough idea." Again, your bill would facilitate doing that under the Bankruptcy Code.

So, the point is, is that if we can actually amend the Bankruptcy Code to make it absolutely certain that SPoE can be carried out successfully under the Bankruptcy Code, then, in fact, it will reduce the need for Title II, which, I think, is a good thing, because SPoE will now be carried out under a system that is rule based and predictable, and it is really the strategy that everybody believes works. No one is arguing whether Title II or bankruptcy are better. It is really the strategy, and the thing that you want to accomplish with your bill, and I think your bill accomplishes it, is to create a framework of bankruptcy law that will facilitate the single point of entry strategy being able to be carried out.

Chairman TOOMEY. Professor Johnson, I want to give you a chance to respond, because I know you want to say something, but if you could do that briefly. I do have a quick question for Professor Jackson before my time expires.

Mr. JOHNSON. I think you put the question brilliantly and with great clarity, Senator. And unfortunately, changes to the Bankruptcy Code being discussed today cannot create the expectation that this is what would happen to these firms because they are so global, and because we have agreed, actually, completely, that there can be no cooperation between global authorities in the event of these failures.

And in Footnote 14 [of my testimony], I put a link to a corporate data base where they do a visualization of all the interconnections between these pieces of these banks across borders, and I really hope that you and your staff will look at it and look at the complexity there and think about how that unravels when the regulators do not cooperate in the event of bankruptcy. And, that is what Mr. Guynn said. They will not cooperate, only in the event of resolution, Title II, and we are trying to avoid Title II. So, under

bankruptcy, there will be no cooperation. It will be a grab for assets globally and the whole thing will collapse.

Chairman TOOMEY. Thank you, Professor Johnson.

Let me touch on something. Professor Jackson, we have not talked about much yet, but I think it is worth mentioning. It is my understanding in Title II, the orderly liquidation authority, the bridge company that is contemplated is actually established as a Government entity——

Mr. JACKSON. Yes.

Chairman TOOMEY. ——exempt from taxes. The FDIC appoints the management team. So, does the FDIC have the expertise to really oversee and manage an organization like this, and what are the implications of having this as a Government entity?

Mr. JACKSON. Well, I am quite concerned in terms of—I think markets regulate better than regulators most of the time, and that is why the bridge institution in bankruptcy is preferable to an FDIC running an institution. I am very uncomfortable with the idea that it is a Government entity exempt from taxation, because that prefers it over the other institutions that it is competing against. I think that is a big mistake in Dodd-Frank, to have done that in the first place.

Commenting a little bit, I think the bankruptcy process that your bill invokes, I actually think—and here, I disagree a little bit with both Randy and with Professor Johnson, is something that I think the FDIC will back and the FDIC can sell it to the foreign regulators. They can make it clear that this—you are not concerned about the claims resolution process that might drag on for a year or 2 years in bankruptcy. You are talking about a recapitalization that occurs through the bankruptcy process, ends up with a bridge company that is not in bankruptcy 48 hours later. I do not think that is a particularly hard thing to sell to regulators with the backing of the FDIC, which I think they would back.

Chairman TOOMEY. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you very much.

I wanted to submit for the record a letter from the National Bankruptcy Conference, if there is no objection to that.

Chairman TOOMEY. Without objection.

Senator MERKLEY. I found it interesting. It was addressed to the Judiciary Committee here in the Senate. It is from June 18 of this year. But, they wanted to share some comments. They noted that the National Bankruptcy Conference is a nonpartisan, not-for-profit organization of 60 of the Nation's leading bankruptcy judges, professors, and practitioners, and it has provided advice to Congress on bankruptcy legislation for 80 years.

They did proceed to share in bullet form some of their concerns, and then this letter expands on each of them. The first point they make is that the Conference believes that a bankruptcy process might not be best equipped to offer the expertise, speed, and decisiveness needed to balance systemic risk and other competing goals in connection with resolution of a SIFI.

The Conference strongly believes that laws in place with regard to a regulator-controlled SIFI resolution process, like the Federal Deposit Insurance Act and orderly liquidation authority under Title

II, should continue to be available, even if special provisions are added to the Bankruptcy Code.

They expand on that later, and then they note in their fourth bullet that the—and I will just summarize here—that any procedure contemplating the use of bankruptcy to recapitalize a SIFI should not include provisions that limit the availability of lender of last resort liquidity to a recapitalized firm, and then they expand on why that is important.

And, of course, this is all directed toward that moment of chaos that we saw when companies that we may have thought were going to be incredibly strong and here forever suddenly find themselves having made big bets that go bad and the world changes overnight.

But—so, I have submitted that for the record, but I wanted to turn to one piece of this puzzle that I thought maybe could have a little bit more expanded discussion, and this is the challenge of the international structure of these firms, where some of these firms may have, as I understand it, a thousand subsidiaries scattered across the globe and the bankruptcy process in the United States kind of extends to our borders, and whether there is sufficient power within the bankruptcy system to address the complexity of this sprawling holding companies. So, in that regard, in terms of the international dimensions, I just thought I would invite comment from any of you who would like to share.

Yes, Mr. Johnson.

Mr. JOHNSON. So, I have talked about this a great deal with counterparts in other parts of the world, and I will tell you what a senior former Bank of England official says. And, off the record, I will tell you afterwards exactly who this is and you can check it yourself. He says that there is a good chance they would cooperate with the FDIC if you are pursuing a Title II-type resolution. He says there is no chance, none, that the U.S. regulators would cooperate if you are following a Title I bankruptcy under current process. And, I am afraid that would also apply—well, you can show them this law and——

Chairman MERKLEY. The U.S. regulators or that the——

Mr. JOHNSON. The U.K. regulators, your foreign regulators——

Chairman MERKLEY. OK.

Mr. JOHNSON. Thank you—would not cooperate with the U.S. bankruptcy process. So, then you have Lehman-type chaos. That is the core of Lehman-type chaos.

And, by the way, Senator, my understanding is the record number of subsidiaries right now is not 1,000, it is 15,000, one of these large companies, with very complicated interconnections that change on a daily basis. So, you have got to unravel that with no cooperation internationally. It collapses. It collapses like a house of cards, and that is what happened in September 2008.

Chairman MERKLEY. Thank you.

Other perspectives?

Mr. GUYNN. Yes. So, can I just explain why that is a red herring when you are using the bankruptcy for a single point of entry strategy. In a single point of entry, the only entity that actually goes into any kind of bankruptcy proceeding is the U.S. parent. The U.K. subsidiaries stay open and operating. They are recapitalized. They have enough liquidity. So, there really is not any decision for

the U.K. regulatory authorities to do or to cooperate with in that situation. So, I think it is really overblown.

Part of the reason for actually inventing single point of entry was to address the cross-border issues that would have arisen if you actually put an institution into a receivership or insolvency proceeding with branches in different countries, where if you tried to do a transfer to a bridge, you would actually need approval of regulatory authorities and counterparties if you were to transfer, for instance, a bank to a bridge bank. Those issues are avoided when you do the single point of entry under this bill. So, that is basically my response.

Chairman MERKLEY. OK. So, Professor Taylor, and then we will return to Professor Johnson.

Mr. TAYLOR. Just very briefly, I think one way to get a handle on this important question is to think about what would have happened in the case of Lehman Brothers had this existed, and we have worked through that in a lot of detail. And, assuming that the existing bail-in mechanism in the European Union exists, and it works fine. It is just exactly what Mr. Guynn and Mr. Jackson are talking about. There is not that much need for coordination. I cannot believe the regulators would stiff us on something like this. There is plenty of time to communicate, and it works together with our current bail-in process.

Chairman MERKLEY. So, dramatically different points of view. Professor Johnson's, and then, Mr. Guynn, you are noting that it is a red herring, and Professor Taylor, that it would work just fine. Back to Professor Johnson.

Mr. JOHNSON. Senator, I work on international policy coordination issues for a long time. This is not a red herring and nobody is stiffing anyone. They have a legal requirement in the United Kingdom and other jurisdictions to protect their own taxpayers, protect people who have claims on the legal entities there. In the event of the failure of Lehman, the concern of the U.K. was, or the question was, who owns what within that complex set of firms. The cash is in London at this moment. Perhaps it belongs to the U.K. company. Perhaps it belongs to the U.S. company. Perhaps it belongs to the Cayman company. We freeze the cash. The first thing we do is we freeze the cash.

Now, under Title II, and that is the point of the Memorandum of Understanding between the FDIC and the Bank of England, the Bank of England has agreed to back off for as long as they believe that you are doing the single point of entry under Title II. So, we will see if that works.

That is not available under bankruptcy. That is not what they will do if you are pursuing either bankruptcy with these current complex global entities under the existing code or under the code with the modifications being suggested by the panel or by the Chairman today. That is not the world in which we live.

Senator MERKLEY. Thank you. And, the world within which we live is limited in time, and thank you very much, all of you, for bringing your expertise to bear on this. I think we are going to have more discussions as time passes and you have added a great deal. Thank you.

Chairman TOOMEY. And, I want to thank all of the witnesses, as well. I think we have had a very helpful, very constructive discussion at advancing the cause and the understanding of this issue. So, I want to thank the witnesses and thank the Ranking Member for attending and participating.

The hearing is adjourned.

[Whereupon, at 11:54 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF RANDALL D. GUYNN

PARTNER, DAVIS POLK & WARDELL, LLP

JULY 29, 2015

Thank you for inviting me to testify on the role of bankruptcy reform in addressing too big to fail (TBTF). I am the head of the Financial Institutions Group at Davis Polk & Wardwell LLP.[1] I am also the Cochair of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center. I have written a number of articles and participated in a number of debates on the nature of the TBTF problem and how to solve it.[2] Like most U.S. and foreign regulators, financial industry groups, think tanks, rating agencies, and other stakeholders,[3] I believe that the most promising solution to the TBTF problem for most of the U.S. and foreign banking organizations that have been designated by the Financial Stability Board (FSB) as global systemically important banking groups (G–SIBs) is the single-point-of-entry (SPoE) recapitalization within resolution or bankruptcy strategy.

During the past few years, I have spent a significant portion of my time working on resolution plans for a number of U.S. and foreign banking organizations under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). I have also represented a number of financial industry trade organizations, including The Clearing House Association, the Securities Industry and Financial Markets Association, the Global Financial Markets Association, and the Financial Services Forum on issues related to recovery and resolution planning, including the ISDA Resolution Stay Protocol (the "ISDA Protocol")[4] and the FSB's proposal on total loss-absorbing capacity (TLAC).[5] I am here today, however, in my individual capacity and not on behalf of any client, although I expect to be asked by clients to help them evaluate the various proposals for bankruptcy reform.

Congress is currently considering two bankruptcy reform proposals that are designed to address the TBTF problem. Both are based on the pioneering work of the Hoover Institution on a proposed new Chapter 14 of the Bankruptcy Code.[6] The House passed H.R. 5421, the Financial Institutions Bankruptcy Act (FIBA), last year, and is considering a nearly identical version of it this year. Two years ago, Senators Cornyn and Toomey introduced S. 1861, the Taxpayer Protection and Responsible Resolution Act (TPRRA). This year, they have introduced a substantially revised version of TPRRA. Both the Senate and House bills are modeled on the SPoE portion of what the Hoover Institution calls Chapter 14 2.0.[7] That portion of

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[1] My practice focuses on providing bank regulatory advice to the largest and most systemic U.S. and foreign banking organizations, as well as to a wide range of U.S. regional, midsize, and community banks. This focus includes advice on mergers and acquisitions, capital markets, and other transactions when the target or issuer is a banking organization. I am the editor of *Regulation of Foreign Banks and Affiliates in the United States* (Thomson Reuters: 8th ed. 2014), the leading treatise in the area.

[2] See, e.g., Randall D. Guynn, "Framing the TBTF Problem: The Path to a Solution", in *Across the Divide: New Perspectives on the Financial Crisis* (Hoover Institution and Brookings Institution: Martin Neil Baily and John B. Taylor, eds., 2014); John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, "Too Big to Fail: The Path to a Solution, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center" (BPC Report); Randall D. Guynn, "Resolution Planning in the United States", in *The Bank Recovery and Resolution Directive—Europe's Solution for "Too Big To Fail"?* (De Gruyter: Andreas Dombret and Patrick Kenadjian, eds., 2013); Randall D. Guynn, "Are Bailouts Inevitable?", 29 *Yale Journal on Regulation* 121 (2012); Debate Between Dean Paul Mahoney of the University of Virginia School of Law and Randall D. Guynn, "Are Bailouts Inevitable?" (available at: *http://volokh.com/2011/03/04/uva-debate-are-bailouts-inevitable-under-dodd-frank/*).

[3] Guynn, "Framing the TBTF Problem", supra note 2, at 282–286.

[4] International Swaps and Derivatives Association, Inc., ISDA 2014 Resolution Stay Protocol (Nov. 4, 2014).

[5] Financial Stability Board, "Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution", Consultative Document (Nov. 10, 2014).

[6] See, e.g., *Bankruptcy Not Bailout: A Special Chapter 14* (Hoover Institution: Kenneth E. Scott and John B. Taylor, eds., 2012); *Making Failure Feasible: How Bankruptcy Reform Can End "Too-Big-To-Fail"* (Hoover Institution: Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor, eds., 2015).

[7] Thomas H. Jackson, "Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions", in *Making Failure Feasible*, supra note 6, at 23; David A. Skeel, Jr., "Financing Systemically Important Financial Institutions", in *Making Failure Feasible*, supra note 6, at 62; John B. Taylor, "Preface", in *Making Failure Feasible*, supra note 6, at xii; William F. Kroener III, "Revised Chapter 14 2.0 and Living Will Requirements Under the Dodd-Frank Act", in *Making Failure Feasible*, supra note 6, at 247.

the revised version of the original Chapter 14 proposal is designed specifically to facilitate an SPoE strategy (or what Professor Jackson calls the one-entity or two-entity recapitalization approach) under the Bankruptcy Code. [8]

This statement first discusses the nature of the TBTF problem. It then describes the SPoE strategy, including how it works, how it inevitably results in a substantial shrinkage of the failed banking group and why it is a viable solution to the TBTF problem. It then discusses the changes made since the 2008 global financial crisis to make U.S. banking groups more resilient against failure. Next, it describes the major structural changes that have been made by the U.S. G–SIBs so that they are safe to fail. [9] Finally, it discusses how bankruptcy reform can improve the ability of the Bankruptcy Code to address too big to fail.

1. Nature of the TBTF Problem

The TBTF problem arises if policymakers do not believe they can allow certain large, systemically important banking groups to fail and impose losses on their private sector investors without risking the sort of contagious runs by short-term creditors or a disruption in critical operations that can destabilize the financial system. [10] Faced with a dilemma between taxpayer-funded bailouts and a potential collapse of the financial system, policymakers tend to choose bailouts as the lesser of two evils. [11] If there were no viable solution to that dilemma, bailouts would almost certainly be inevitable. [12] Thomas Huertas provides a good discussion of why TBTF is a problem and why it should be solved in *Safe To Fail: How Resolution Will Revolutionise Banking.* [13]

2. The Single-Point-of-Entry Strategy

But there is a viable solution if certain conditions are satisfied. It is called the SPoE resolution strategy. That strategy was originally developed by the FDIC under Title II of the Dodd-Frank Act. [14] It was subsequently endorsed by the Bank of England as the most promising strategy for dealing with failed G–SIBs without the need for taxpayer-funded bailouts and without causing the sort of contagion that can destabilize the financial system. [15] The European Union added language to its Bank Recovery and Resolution Directive authorizing resolution authorities at both the member state and union levels to resolve European banking and other financial organizations using the SPoE strategy. [16] The Failure Resolution Task Force at the Bipartisan Policy Center recognized that the SPoE strategy could be carried out under existing Chapter 11 of the Bankruptcy Code, but recommended that a new Chapter 14 be enacted to increase the legal certainty of SPoE under the Bankruptcy Code. [17]

a. How SPoE Works

Under the SPoE strategy, the top-tier parent of a U.S. banking group would be put into a special resolution proceeding under Title II of the Dodd-Frank Act or a Chapter 11 bankruptcy proceeding. The FDIC under Title II or the debtor-in-possession in a Chapter 11 proceeding would establish a new financial holding company

[8] See supra note 7.

[9] Cf. Thomas Huertas, *Safe To Fail: How Resolution Will Revolutionise Banking* (Palgrave Macmillan: 2014).

[10] Douglas Diamond and Philip Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", 91 *Journal of Political Economy* 401 (1983); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, Remarks at The Clearing House 2014 Annual Conference, New York, New York, at 2 (Nov. 20, 2014).

[11] BPC Report supra note 2, at 1; "Guynn, Are Bailouts Inevitable?", supra note 2, at 127–129.

[12] Guynn, "Are Bailouts Inevitable?", supra note 2, at 129. See also Thomas F. Huertas, "A Resolvable Bank", in *Making Failure Feasible*, supra note 6, at 129 ("A resolvable bank is one that is 'safe to fail': it can fail and be resolved without cost to the taxpayer and without significant disruption to the financial markets or the economy at large.").

[13] Huertas, supra note 7, chapter 1, at 4–20.

[14] Martin J. Gruenberg, Acting Chairman, FDIC, Remarks to the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012).

[15] FDIC and Bank of England, Joint Paper, "Resolving Globally Active, Systemically Important, Financial Institutions" (Dec. 10, 2012); Martin J. Gruenberg, Chairman, FDIC, and Paul Tucker, Deputy Governor, Financial Stability, Bank of England, "Global Banks Need Global Solutions When They Fail", *Financial Times*, Op. Ed. (Dec. 10, 2012; Bank of England, "The Bank of England's Approach to Resolution" (October 2014).

[16] Directive 2014/15/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council.

[17] BPC Report, supra note 2, at 33–35.

(FHC) called a bridge FHC (because it is a temporary bridge to an exit from the receivership or bankruptcy proceeding). All of the assets of the failed parent, including is ownership interests in its operating subsidiaries, would be transferred to the bridge FHC. This would be done in a bankruptcy proceeding, with court approval, pursuant to Section 363 of the Bankruptcy Code. All of the shares and long-term unsecured debt of the failed parent would remain behind in the receivership or bankruptcy proceeding. Only a limited amount of critical operating liabilities, such as those to the electric company or critical vendors as well as parent guarantees, would be assumed by the bridge FHC, making it essentially debt-free.

The parent or bridge FHC would recapitalize any operating subsidiaries that suffered losses by forgiving intercompany receivables or otherwise contributing assets to the subsidiaries. It would do so because the franchise values of operating subsidiaries are almost always substantially greater than their liquidation values. Thus, recapitalizing the operating subsidiaries should maximize their value for the benefit of the failed parent's stakeholders.

At least in a bankruptcy proceeding the bridge FHC would be transferred to an independent trust, which would hold the interest in the bridge FHC for the benefit of the bankruptcy estate. The trustees of the trust would include experienced and highly regarded bankers, former regulators and others. The trust would enter into an agreement approved by the bankruptcy court that would spell out the duties of the trust to the bankruptcy estate. One key benefit of the trust would be to help gain public confidence in the stability of the bridge FHC.

Once the business transferred to the bridge FHC stabilizes, the FDIC or the trust would convert the bridge to an ordinary bank holding company (New HoldCo) and sell all or a portion of the shares in New HoldCo to the public and distribute the net proceeds and any unsold shares to the receivership or bankruptcy estate. The net proceeds and any unsold shares would then be distributed to the failed parent's stakeholders in accordance with the priority of their claims.

A step-by-step illustration of how an SPoE strategy works is included in the BPC Report,[18] and attached to this Statement as Exhibit A.

b. Principal Strategy Under Title I Resolution Plans

All but two of the U.S. G–SIBs recently disclosed in the public summaries of their 2015 resolution plans submitted under Section 165(d) of the Dodd-Frank Act that their principal strategies for being resolved under the Bankruptcy Code is an SPoE strategy under existing Chapter 11 of the Bankruptcy Code.[19]

c. What Comes Out of the SPoE Hopper Is Not What Goes In

As shown by the step-by-step illustration of the SPoE strategy in the BPC Report,[20] and attached to this Statement as Exhibit A, the SPoE strategy results in the resolution, not the resurrection of a failed banking group. The banking group that emerges from an SPoE strategy is always significantly smaller than it was before its top-tier parent failed. Under the stylized balance sheets used in the BPC Report, the banking group that emerged from the SPoE was half the size of the banking group just before its top-tier parent failed (total assets dropped from 100 to 50), as illustrated by Figures 1 and 7.[21] This is mainly a function of the fundamental nature of the SPoE process, as illustrated by Figure 2 in the BPC Report (where total assets dropped from 100 to 59, to reflect the hypothetical losses suffered by the group).[22] But it may also result from the sale of certain assets during the SPoE process if that would be consistent with maximizing the value of the firm and minimizing its losses for the benefit of the top-tier parent's stakeholders left behind in the Title II receivership or bankruptcy proceeding, as illustrated by Figure 6 in the BPC Report.[23]

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[18] BPC Report, supra note 2, at 23–32.

[19] See the FDIC's Web site, *https://www.fdic.gov/regulations/reform/resplans/index.html,* or the Federal Reserve's Web site, *http://www.federalreserve.gov/bankinforeg/resolution-plans.htm.* The firms that used the SPoE strategy as their principal strategy were Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and State Street. The firms that did not use the SPoE strategy as their principal strategy were the Bank of New York Mellon and Wells Fargo. The principal strategy used by those firms was a multiple-point-of-entry (MPoE) strategy whereby the businesses of their flagship banks were transferred to bridge banks and then, over time, broken up and sold in an FDIC receivership and their material nonbank subsidiaries were sold to third parties as going concerns or wound down in their respective insolvency proceedings.

[20] BPC Report, supra note 2, at 23–32.

[21] Id. at 24, 30.

[22] Id. at 25.

[23] Id. at 30.

This shrinkage principle is illustrated by the public summaries of the 2015 Title I resolution plans recently filed by the U.S. G–SIBs.[24] According to the firms that used the SPoE strategy as their principal strategy,[25] the firm that emerged from the SPoE process was substantially smaller than the firm that entered the process. For example, Bank of America and JPMorgan Chase reported that their main bank subsidiaries would shrink by approximately 33 percent and their broker-dealer subsidiaries would shrink by 66–80 percent.[26] State Street reported that its flagship bank would shrink by 50 percent and it might sell its investment management businesses outside of insolvency proceedings as going concerns.[27] Citigroup, Goldman Sachs, and Morgan Stanley all reported that they would cease to exist because they would sell their operations to third parties in public or private offerings or wind them down outside of any insolvency proceedings as part of the SPoE process.[28] The shrinkage principle in the SPoE strategy, of course, is quite different from breaking up healthy banks for political reasons. Any shrinkage occurring as part of the SPoE strategy is simply a by-product of incurring losses and attempting to maximize the value of the enterprise and minimize its losses for the benefit of the failed parent's stakeholders.

d. SPoE Is a Viable Solution

The SPoE strategy is a viable solution to the TBTF problem if three essential conditions are satisfied.

(1) Sufficient Usable TLAC

First, the failed parent must have enough TLAC (i.e., combined equity and long-term unsecured debt) for the business that is transferred to the bridge FHC to be fully recapitalized after suffering losses in a sufficiently severe adverse economic scenario and the TLAC must be usable. By usable, I mean the group's losses can be imposed on the parent's private sector TLAC investors without fostering runs by the group's short-term creditors, which in turn can foster contagion throughout the financial system.[29] The key to being able to do so is separating the TLAC and other capital structure liabilities from short-term unsecured debt and other operating liabilities, and making the capital structure liabilities subordinate to the operating liabilities (or conversely making the operating liabilities senior to the capital structure liabilities).[30] As a result, both shareholders and long-term unsecured debt investors are expected to bear losses, a result that would be fundamentally different from the 2008 global financial crisis when long-term bondholders were generally insulated from losses and only shareholders bore losses.

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[24] See supra note 19.
[25] Id.
[26] Id. (see public summaries for Bank of America and JPMorgan Chase).
[27] Id. (see pubic summary for State Street).
[28] Id. (see public summaries of Citigroup, Goldman Sachs and Morgan Stanley).
[29] Huertas, supra note 12, at 129.
[30] Id., at 29–30. I believe that I was the first person to suggest this sort of separation and subordination of capital structure liabilities to operating liabilities in connection with the Financial Stability Board's Private Sector Bail-in Initiative, of which I was a member. That concept is now embedded in the FSB's TLAC proposal. See FSB, supra note 5. It was developed in response to what I found to be a persuasive criticism of the FDIC's discretion to discriminate among similarly situated creditors in Section 210(b)(4) of Title II of the Dodd-Frank Act, as long as the disfavored creditors receive at least as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code (the "no creditor worse off than in liquidation" or "NCWOL" principle). Kenneth E. Scott, "A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14", in *Bankruptcy Not Bailout,* supra note 6, at 11–12, 17 ("For my purposes, a bailout occurs when some favored claimants on a failed financial firm are given more than what they would receive in an ordinary bankruptcy, at the expense of others."). When I tried to analyze why the FDIC needed the power to discriminate among similarly situated creditors, it seemed to me that the only legitimate reason was to be able to treat short-term unsecured creditors as if they were senior to long-term unsecured creditors during a financial panic in order to stem runs and contagion. A rule of separation and subordination seemed superior to a discretionary power to achieve the same end since the discretionary power arguably resulted in an unexpected transfer of value from one group of creditors to another without compensation, meaning it could give rise to moral hazard since the favored creditors would not internalize the costs of their unexpected favored position. In contrast, with a clear nondiscretionary rule of separation and subordination in place, the market would force short-term unsecured creditors to internalize the costs of their preferred status by reducing the amount of interest or other return they could demand. At the same time, it would allow long-term unsecured debt holders to demand a return that was sufficient to compensate them for the increased risk they would bear.

The easiest way for U.S. bank holding companies to make TLAC usable is to make it structurally subordinate to the group's short-term unsecured debt.[31] This can be achieved by moving any short-term unsecured debt from the parent to its operating subsidiaries. The TLAC investors will then absorb all losses incurred by the group before any of the short-term unsecured creditors suffers any losses. Because the TLAC would act as a shield against losses by the short-term creditors, imposing losses on TLAC investors should reduce the incentive of the group's short-term unsecured creditors to run. To the extent this subordination framework makes short-term unsecured debt less risky, the market will force short-term unsecured creditors to internalize the costs of their preferred position (and thereby eliminate any moral hazard) by decreasing the returns they would otherwise be able to demand on short-term unsecured debt.

(2) Sufficient Liquidity

Second, the business transferred to the bridge FHC must have access to a sufficient amount of liquidity in a Title II or bankruptcy proceeding for the business to be stabilized after it has been transferred to the largely debt-free bridge FHC. If the business does not have sufficient liquidity, it may be forced to sell illiquid assets at fire-sale prices, which can cause an otherwise solvent bridge FHC to become insolvent.[32] A well-capitalized bridge FHC should be able to obtain secured liquidity from the market under normal market conditions.[33] But if the market for secured liquidity is dysfunctional, as it typically is during a financial crisis, the FDIC has the power to supplement the amount of secured liquidity available from the market in a Title II proceeding.[34]

There is no similar Government source of back-up secured liquidity in a bankruptcy proceeding, and TPRRA would prohibit the Federal Reserve bank from making advances to a covered financial company or a bridge financial company for the purpose of providing court-approved debtor-in-possession financing.[35] A U.S. G–SIB that is required to show it can be resolved under the Bankruptcy Code without any access to secured liquidity from a Government source will be forced to hold far more cash and other high quality liquid assets (HQLAs) than otherwise in order to show it will have enough liquidity in a hypothetical, future bankruptcy proceeding. Such a requirement will reduce the amount of credit the U.S. G–SIBs can supply to the market.[36] It will also provide an incentive for U.S. G–SIBs to hoard liquidity during a financial crisis, when it is most needed by the market.[37]

To illustrate the impact of such a liquidity requirement on the supply of credit, consider how the money multiplier works. If all banks were subject to a 10 percent reserve requirement (RR), it would mean that they are required to set aside $10 in cash for every $100 in loans they make. Since the potential money multiplier is 1/RR, it also means that every dollar of central bank money injected into the banking system by the Federal Reserve has the potential to multiply into 10 times the amount of money and credit throughout the banking system.[38] If the reserve requirement is increased to 20 percent, the amount of potential credit available to the system will shrink by 5 times the amount of central bank money (-500 percent) originally injected into the system. The point is not to say whether 10 percent or 20 percent is the correct reserve requirement, but to illustrate that there is a tradeoff between the amount of the reserve requirement and the amount of money and credit that can potentially be made available to the market.[39]

Liquidity requirements have the same effect on the supply of money and credit as reserve requirements.[40] If U.S. G–SIBs are required to hold twice as much cash and HQLAs as they would be required to hold if a Government source of secured liquidity were available in a hypothetical, future bankruptcy proceeding, the potential amount of credit they can supply to the market will shrink in advance by approximately 5 times the amount of central bank money (-500 percent) originally in-

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[31] Other less practical ways are to amend outstanding long-term senior unsecured debt to make it contractually subordinate to short-term unsecured debt or to persuade Congress to enact a statutory priority scheme that makes long-term unsecured debt subordinate to short-term unsecured debt.

[32] Diamond and Dybvig, supra note 10.

[33] Skeel, supra note 7, at 65–67.

[34] Dodd-Frank Act, §210(n) (Orderly liquidation fund).

[35] Skeel, supra note 7, at 63.

[36] Tarullo, supra note 10, at 5–6.

[37] Id. at 6, 18.

[38] See, e.g., James R. Kearl, *Economics and Public Policy: An Analytical Approach* 422–427, 792 (Pearson: 6th ed., 2011).

[39] See, e.g., Tarullo, supra note 10, at 5–6.

[40] Indeed, reserve requirements are a type of liquidity regulation. Id. at 18, note 18.

jected into the system by the Federal Reserve. In other words, there is a serious tradeoff between the potential amount of credit the U.S. G–SIBs can provide to the market now and the benefits of prohibiting the Federal Reserve from using any of its lender-of-last-resort (LOLR) facilities to provide liquidity to fully recapitalized bridge FHCs in a future, hypothetical bankruptcy proceeding. Assuming that the Federal Reserve would provide such liquidity in accordance with the classic rules laid down by Walter Bagehot [41]—i.e., only on a fully secured basis to solvent bridge FHCs at appropriate above-market interest rates—it would seem as if the risk of loss to the Federal Reserve and the risk of creating any moral hazard would be essentially zero. It therefore seems as if the tradeoff strongly favors the availability of a properly structured LOLR facility to serve as a back-up source of secured liquidity in a bankruptcy proceeding. [42]

For the reasons described in the BPC Report, it is important for policymakers to distinguish between capital and liquidity. [43] Government programs like the Troubled Asset Relief Program (TARP) provided equity capital to both viable and troubled financial firms. TARP bailed out the private sector investors of otherwise insolvent firms by protecting them against losses without requiring those investors to compensate the Government for providing such protection. In contrast, traditional LOLR facilities provide only temporary fully secured liquidity at above-market interest rates to solvent firms with sufficient capital. If properly structured, such facilities expose the Government to no risk of loss and require borrowers to adequately compensate it for the small amount of liquidity risk it assumes. [44] Thus, it is fair and appropriate to label Government injections of capital such as those made under the Capital Purchase Program of TARP as bailouts, [45] but it is wrong to label properly structured LOLR facilities as bailouts.

(3) Mitigation of QFC Cross-Defaults

Third, and related to the second, a material amount of the qualified financial contracts (QFCs) at the group's operating subsidiary level must not contain cross-defaults to the parent's failure. Alternatively, any such cross-defaults must be overridden contractually, for example, as provided by the ISDA Protocol or a similar contractual arrangement or by regulation or statute. Otherwise, such cross-defaults would allow the QFCs to be terminated and drain liquidity out of the group even if the operating subsidiaries have been recapitalized and are performing on those QFCs. In addition, collateral securing the QFCs would be dumped on the market, putting downward pressure on asset values. Such a potential drainage of liquidity would require U.S. G–SIBs to carry even more cash and HQLAs in order to be sure they would have enough liquidity in a hypothetical, future bankruptcy proceeding, putting further pressure on their ability to supply credit to the market and increasing their incentive to hoard liquidity during a financial crisis. [46]

3. U.S. Banking Groups Are More Resilient

U.S. banking groups have taken substantial actions to make themselves more resilient against failure since the 2008 global financial crisis. For example, as shown in Exhibit B, the largest, most systemic banking groups have nearly twice as much capital as they had on the eve of the 2008 financial crisis. They are also projected to have more capital in a stressed environment than they had actual capital in 2008. This makes them more resilient against insolvency. They also have significantly more liquid balance sheets, making them more resilient against runs, as illustrated in Exhibit C. They have three times (3X) the amount of HQLAs compared to 2008, and five times (5X) the amount of cash. They have also reduced their reliance on short-term wholesale funding, as shown in Exhibit D. U.S. regulatory standards increase with the size and complexity of U.S. and foreign banking organizations, as shown in Exhibit E.

[41] Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873).

[42] See David A. Skeel, Jr., supra note 7, at 65, 74–75, 81–85. Indeed, Professor Skeel argues that Congress should amend Section 13(3) of the Federal Reserve Act to expressly authorize the Federal Reserve to provide secured liquidity to bridge financial companies and their operating subsidiaries in order to facilitate an SPoE strategy under the Bankruptcy Code. Id. at 65.

[43] BPC Report, supra note 2, at 19.

[44] Tarullo, supra note 10, at 9. Paul Tucker, The lender of last resort and modern central banking principles and reconstruction, BIS Papers No. 79 (Sept. 2014).

[45] See Davis Polk, *A Guide to the Laws, Regulations ,and Contracts of the Financial Crisis*, chapter 3 (Margaret Tahyar, ed., September 2009).

[46] Tarullo, supra note 10, at 6, 18.

4. U.S. G–SIBs Are Safe To Fail Under the Bankruptcy Code

The U.S. G–SIBs have made major structural changes so that they will be safe to fail under the Bankruptcy Code.[47]

a. More Usable TLAC

The most important structural change that almost no one has heard of relates to usable TLAC, as illustrated on Exhibit F. The U.S. G–SIBs had, on average, nominal TLAC equal to approximately 17 percent of their risk-weighted assets (RWAs) in 2008.

Unfortunately, only tangible common equity turned out to be loss-absorbing without risking contagion because of how the TLAC was structured, and tangible common equity amounted to only 5 percent of RWAs. Losses could not legally be imposed on long-term senior unsecured debt without causing contagion because it ranked equally with short-term senior unsecured debt issued at the parent level. There was no provision in the Bankruptcy Code that allowed bankruptcy courts to discriminate among similarly situated creditors unless it would maximize the value of the enterprise for the benefit of the disfavored creditors.[48] Although losses could theoretically have been imposed on subordinated debt, preferred equity and trust preferred securities without causing contagion, the market was confused about the relative priority among those instruments and long-term senior unsecured debt so policymakers worried about causing contagion if such securities were allowed to suffer any losses.

Today the U.S. G–SIBs have, on average, nominal TLAC equal to approximately 25 percent of RWAs, as illustrated by Exhibit F. More importantly, they have restructured their TLAC so that it is all usable to absorb losses without causing contagion.[49] This means that they have five times (5X) the amount of usable TLAC (which consists of both equity and long-term unsecured debt) compared to what they had during the 2008 global financial crisis. They have achieved this result by moving virtually all of the short-term unsecured debt that used to be issued by their top-tier parent companies to their operating subsidiaries. Long-term senior unsecured debt can now be left behind in an FDIC receivership or bankruptcy proceeding of the parent without imposing losses on the group's short-term unsecured debt. This amount of TLAC should be enough to recapitalize the business transferred to a bridge FHC at full Basel III capital levels under conditions twice as severe as the 2008 global financial crisis.

Both the market and the regulators expect this structural change to make U.S. G–SIBs more resolvable under the Bankruptcy Code, as shown on Exhibit G. For example, Fitch and Moody's have eliminated any uplift on the ratings of U.S. G–SIBs based on an expectation of Government support because Government bailouts are no longer expected.[50] Standard & Poor's has indicated that it may eliminate any uplift based on an expectation of Government support.[51] The spreads on long-term unsecured debt of U.S. G–SIBs are now higher than the spreads on long-term unsecured debt issued by other U.S. banks.[52]

b. Increased Liquidity

As noted above, the U.S. G–SIBs have substantially more cash and HQLAs than in 2008. Several of them have increased their cash and HQLAs in order to show they would have enough liquidity to carry out an SPoE resolution strategy under Chapter 11, assuming no access to secured liquidity from any Government LOLR facility. This new liquidity requirement may have already started to result in a higher effective liquidity requirement than either the Basel III liquidity coverage ratio or net stable funding ratio. It raises serious public policy questions whether this new liquidity requirement is justified in light of the negative impact it may already be having on the potential amount of credit that the U.S. G–SIBs are able to provide to the U.S. economy.[53]

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[47] Cf. Huertas, supra note 9.

[48] See, e.g., Douglas G. Baird, *Elements of Bankruptcy* 225–226 (5th ed. 2010). In contrast, the FDIC has the discretion to treat similarly situated creditors differently under Section 210(b)(4) of the Dodd-Frank Act as long as the disfavored creditors receive at least as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code.

[49] See Huertas, supra note 12, at 129.

[50] Government Accounting Office, "Large Bank Holding Companies: Expectations of Government Support", at 25–26 (July 2014). Moody's Investors Service, "Rating Action: Moody's Concludes Review of Eight Large U.S. Banks" (Nov. 14, 2013).

[51] GAO, supra note 50.

[52] Id. at 50–52.

[53] Tarullo, supra note 10, at 5–6, 18.

c. Mitigation of QFC Cross-Defaults

Five of the eight U.S. G–SIBs [54] are among the 18 G–SIBs [55] that agreed to adhere to the new ISDA Resolution Stay Protocol. As summarized in the slide attached as Exhibit H, the ISDA Protocol overrides cross-defaults in ISDA financial contracts among the 18 adhering G–SIBs based on a parent's or other affiliate's bankruptcy or entry into resolution. The adhering U.S. G–SIBs have also supported regulations to expand the principles of the ISDA Protocol to more counterparties and financial contracts. No similar mechanism existed during the 2008 financial crisis. According to the Financial Stability Board, "[w]ith the adoption of the [ISDA] protocol by the top 18 dealer G–SIBs in November, over 90 percent of their OTC bilateral trading activity will be covered by stays of either a contractual or statutory nature." [56] The FDIC and the Federal Reserve described the ISDA Protocol as "an important step toward mitigating the financial stability risks associated with the early termination of bilateral, OTC derivatives contracts triggered by the failure of a global banking firm with significant cross-border derivatives activities." [57]

d. Other Actions

The U.S. G–SIBs have also made a number of other structural changes and taken a number of other actions to make themselves more resolvable under the Bankruptcy Code. These include restructuring and other actions to ensure the continuity of shared services throughout the resolution process, improving operational capabilities, and preserving access to financial market utilities. In addition, the U.S. regulatory agencies have taken significant actions to improve coordination with foreign regulators. [58]

e. Regulator Recognition

The regulators have noticed how much progress the U.S. G–SIBs have made in making themselves safe to fail under the Bankruptcy Code. FDIC Chairman Martin Gruenberg has described the progress as transformational and impressive, and perhaps underappreciated. See Exhibit I for a representative set of quotes from selected regulators.

5. Role of Bankruptcy Reform in Addressing Too Big To Fail

While I believe that the actions taken above should make SPoE feasible under the existing Bankruptcy Code, bankruptcy reform would enhance the ability of the Bankruptcy Code to address too big to fail by making four key additions:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that Section 363 of the Bankruptcy Code can be used to transfer the recapitalized operating subsidiaries to a new holding company using a bridge company structure.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.
- Providing for some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns. [59]

The first two of these features would increase the certainty of application of current law to actions that must be taken in connection with an SPoE strategy in bankruptcy. [60]

The third of these features currently is being addressed by contractual workarounds like the ISDA Protocol, but it would be far better if the Bankruptcy Code were amended to include a provision similar to Section 210(c)(16) of the Dodd-

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[54] The adhering U.S. G–SIBs are Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley. See ISDA Press Release (Oct. 11, 2014).

[55] The adhering non-U.S. G–SIBs Are Bank of Tokyo-Mitsubishi UFJ, Barclays, BNP Paribas, Credit Agricole, Credit Suisse, Deutsche Bank, HSBC, Mizuho Financial Group, Nomura, Royal Bank of Scotland, Societe Generale, Sumitomo Mitsui Financial Group, and UBS. Id.

[56] Financial Stability Board, Press Release (October 11, 2014).

[57] Federal Reserve and FDIC, Joint Press Release (October 11, 2014).

[58] See Statement of Donald S. Bernstein Before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House Committee on the Judiciary at 6–7 (July 9, 2015).

[59] Id. at 8–9.

[60] Id. at 9.

Frank Act that provides for the override of cross-defaults under QFCs in an SPoE resolution under the Bankruptcy Code.[61]

The last of these features is currently being addressed by the substantially increased liquidity reserves on the balance sheets of most of the U.S. G–SIBs, though once they have been recapitalized in an SPoE resolution, there is no reason why traditional, secured LOLR facilities should not be available to nonbankrupt, fully capitalized, going concern subsidiaries of the firms.[62] The availability of such liquidity, if properly structured, would involve no risk of loss to taxpayers and would help to mitigate any panic run on subsidiary liquidity after the holding company commences its bankruptcy proceedings.[63]

Although TPRRA includes most of these features, it contains a provision that would prohibit the Federal Reserve from providing liquidity to a bridge FHC for the purpose of providing court-approved debtor-in-possession financing under the Bankruptcy Code. I believe this provision should be deleted.[64] My view is consistent with the position recently taken by the National Bankruptcy Conference (NBC), which essentially made the same observation and recommendation.[65] In addition, if TPRRA fails to allow the Federal Reserve to provide secured liquidity to a bridge FHC under the Bankruptcy Code, the U.S. G–SIBs may be forced to hold more cash and HQLAs than otherwise. This will sharply reduce the amount of credit they can make available to the market and give them a powerful incentive to hoard liquidity during a financial crisis, when it is most needed by the market.[66] Finally, the absence of a Government LOLR facility in a bankruptcy proceeding will increase the range of circumstances under which Title II can be lawfully invoked.[67]

TPRRA would also repeal Title II of the Dodd-Frank Act. Largely for the reasons stated by the NBC,[68] I believe this would be inadvisable. While I would prefer that a new Chapter 14 be added to the Bankruptcy Code to minimize the circumstances under which Title II can be lawfully invoked to the bare minimum,[69] I believe that there is value in preserving Title II for several reasons. First, it may be necessary to have a provision like Title II to be able to have a Government source of backup secured liquidity in the event of a liquidity famine in the market during a future financial crisis. Second, there may be certain unforeseeable emergency circumstances that would justify a compromise with the rule of law in favor of allowing the FDIC to exercise the broad range of discretion granted by Title II, which a bankruptcy court does not have under the Bankruptcy Code.

Third, foreign jurisdictions do not have a tradition of recapitalizations or reorganizations under their insolvency laws. As a result, foreign regulators associate insolvency laws with liquidations, not recapitalizations or reorganizations. To provide for recapitalizations or reorganizations of financial firms, these foreign jurisdictions have created special resolution regimes (SRR) run by administrative agencies rather than courts. These SRRs are substantially similar to Title II of the Dodd-Frank Act and the bank resolution provisions in the Federal Deposit Insurance Act. As a result, many foreign regulators have an almost impossible time understanding or accepting that an SPoE strategy can be executed effectively under the Bankruptcy Code. It is therefore useful to preserve Title II to foster cross-border confidence and

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[61] Id.

[62] Skeel, supra note 7, at 65 (arguing that Congress should amend Section 13(3) of the Federal Reserve Act to expressly permit the Federal Reserve to make secured liquidity available to a bridge financial company and its operating subsidiaries to facilitate an SPoE resolution under the Bankruptcy Code).

[63] Bernstein, supra note 58, at 9.

[64] Professor Skeel would go a step further and argue that Congress should amend Section 13(3) of the Federal Reserve Act to expressly authorize the Federal Reserve to provide secured liquidity to a bridge financial company and its operating subsidiaries to facilitate an SPoE resolution under the Bankruptcy Code. Skeel, supra note 7, at 65. While I agree with Professor Skeel's view, I believe that it would be worth enacting TPRRA even if it does not contain such an express authorization.

[65] Letter dated June 18, 2015, from the National Bankruptcy Conference to the Honorable Tom Marino, Chairman of the House Subcommittee on Regulatory Reform, Commercial and Antitrust Law, the Honorable Hank Johnson, the Ranking Member of that Committee, the Honorable Chuck Grassley, the Chairman of the Senate Committee on the Judiciary, and the Honorable Patrick J. Leahy, Ranking Member of that Committee (NBC Letter), at 7.

[66] Tarullo, supra note 10, at 5–6, 18.

[67] Under Section 203(b)(2) of the Dodd-Frank Act, Title II can only be lawfully invoked if the resolution of a covered financial company under the Bankruptcy Code would have serious adverse effects on financial stability in the United States. The resolution of such a company under the Bankruptcy Code is more likely to have serious adverse effects on U.S. financial stability if the Federal Reserve is prohibited from providing secured liquidity to solvent entities at appropriate above-market interest rates to facilitate resolution under the Bankruptcy Code.

[68] NBC Letter, supra note 65, at 3–5.

[69] See supra note 67.

cooperation in the U.S. resolution process. Such confidence and cooperation would almost certainly be undermined if Title II were repealed.

Conclusion

While the U.S. G–SIBs have made substantial progress showing that an SPoE strategy can be executed under existing Chapter 11, bankruptcy reform has the potential to increase the legal certainty of that outcome. Indeed, I believe that the proposed TPRRA would increase the ability of the Bankruptcy Code to address too-big-to-fail with two modifications. First, the provisions prohibiting the Federal Reserve from providing advances to bridge financial companies in a bankruptcy proceeding for the purpose of providing it with debtor-in-possession financing should be deleted. Second, while it is desirable for TPRRA to reduce the circumstances under which Title II of the Dodd-Frank Act can be lawfully invoked to the bare minimum, it should not entirely repeal Title II.

EXHIBITS TO STATEMENT OF

RANDALL D. GUYNN

HEAD OF THE FINANCIAL INSTITUTIONS GROUP
DAVIS POLK & WARDWELL LLP

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER PROTECTION

OF THE

SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

"THE ROLE OF BANKRUPTCY REFORM
IN ADDRESSING TOO-BIG-TO-FAIL"

JULY 29, 2015

Exhibit A

Step-by-Step Illustration of How SPoE Works
(from BPC Report)

The OLF is an unusual creation. As a result, the application of the ordinary governmental budgetary scoring has not produced logical results. For example, in implementing the government-wide sequester, the Office of Management and Budget (OMB) determined that there were $77 million in "savings" by implementing the sequester on the OLF. This makes no sense, given that the OLF has never been used and its use is not contemplated absent the failure and resolution of a SIFI under OLA. Another example is the Congressional Budget Office's (CBO) decision to score the repeal of OLA as providing "savings" to the government. The logic behind CBO's score has to do with the temporal sequencing of events over a ten-year time horizon. Specifically, CBO's practice is to assume a small but non-zero probability of use in each year, with repayment coming after the end of the ten-year period. Thus, if there is a failure in years nine or ten of the ten-year window, the government has to provide funding for OLF immediately but is not repaid until after year ten, which is outside the budget window.

In reality, if the OLF is used properly to provide only temporary, fully secured liquidity to recapitalized entities and not to provide capital to insolvent entities, it should not cost the taxpayers (or other financial institutions) anything. Both the Administration and some in Congress have used budgetary scoring rules in ways that are not consistent with what should occur. Both sides should debate these issues on their merits and not use artificial scoring results in ways that are not consistent with what taxpayers will actually experience.

SINGLE-POINT-OF-ENTRY (SPOE) RECAPITALIZATION STRATEGY

The FDIC has the authority to develop strategies for implementing its power under OLA whenever the conditions for invoking OLA are satisfied. FDIC Chairman Gruenberg recently announced that the FDIC's preferred strategy for resolving the largest and most complex financial groups under OLA is the SPOE recapitalization strategy. The key elements of the strategy can be executed over a weekend or even overnight. It imposes ***all losses*** on the parent company's ***shareholders and long-term unsecured debt holders***, as well as any other holders of comparable capital structure liabilities of the parent, and ***not on taxpayers***. If the parent has sufficient loss-absorbing resources in its capital structure and sufficient access to liquidity, this strategy ensures that all short-term obligations and other similar operating liabilities of the group, including demand deposits, are satisfied in a timely manner.

The FDIC has issued a joint paper with the Bank of England advocating the SPOE recapitalization strategy for resolving G-SIFIs. FDIC Chairman Gruenberg and Bank of England Deputy Governor for Financial Stability Paul Tucker also jointly published an editorial in the *Financial Times* lauding the SPOE recapitalization strategy for resolving G-SIFIs without a taxpayer-funded bailout.

The FDIC has indicated that it intends to propose a policy statement or regulation describing how it will use its authority under OLA to resolve a covered financial company using the SPOE recapitalization strategy.

The FDIC will probably continue to use its pre-existing tools for resolving SIFIs on the less complex, more domestic and smaller end of the continuum between D-SIFIs with $50 billion in assets and G-SIFIs with over $1 trillion in assets. This means that it would probably continue to use its tool of choice under the FDI Act – ***purchase-and-assumption transactions*** – to resolve any bank subsidiary of a domestic or D-SIFI's parent holding company. This tool involves the sale of a failed bank to one or more healthier third-party banks through an auction process, with or without loss-sharing supported by the industry-funded Deposit Insurance Fund. Moreover, as long as the consolidated operations of the parent holding companies of D-SIBs are essentially domestic in nature, the FDIC will probably also allow their parents to be reorganized or liquidated under the Bankruptcy Code rather than invoking OLA to resolve them.

The SPOE recapitalization strategy is one way to resolve SIFIs, including G-SIFIs, without creating contagious panic or resorting to taxpayer-funded bailouts. As a result, it is a viable solution to the too-big-to-fail problem if properly implemented. The FDIC's decision to use SPOE is a significant, positive step toward ending the too-big-to-fail problem.

Figures 1, 2 and 3 illustrate the before and after scenarios of the first step in a SPOE recapitalization of a stylized U.S. G-SIFI.

Figure 1. SPOE: Group Structure Before Recapitalization

Parent Only Balance Sheet

Deposits / advances to subs	45	Unsecured long-term debt	50
Equity in subs	45	Unsecured short-term debt	5
Other assets	10	Secured liabilities	0
Total	**100**	Other liabilities	0
		Equity	45
		Total	**100**

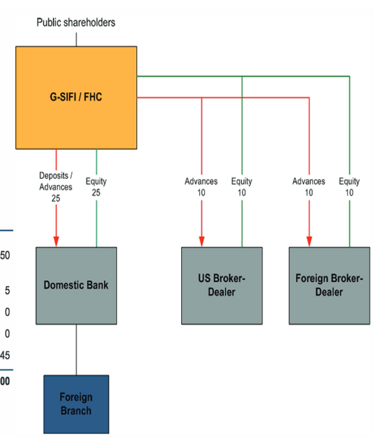


Figure 2. SPOE: Hypothetical Losses

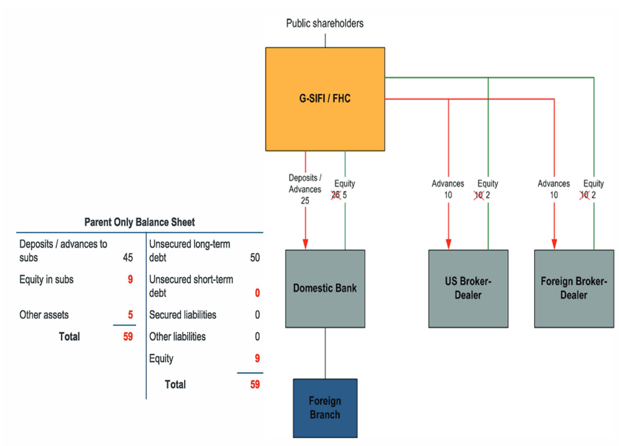
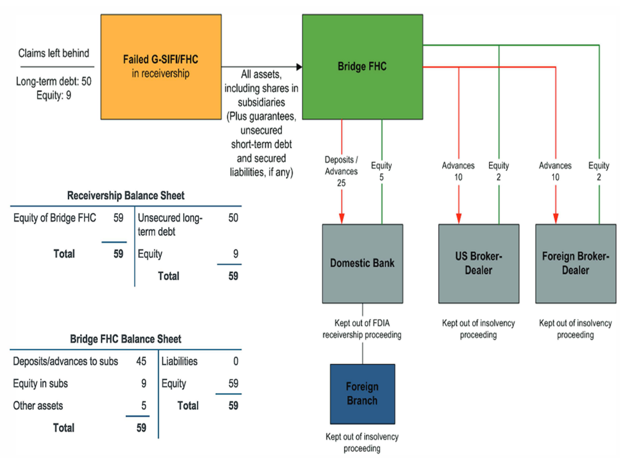


Figure 3. SPOE Step 1: Recapitalizing Business Transferred to Bridge FHC

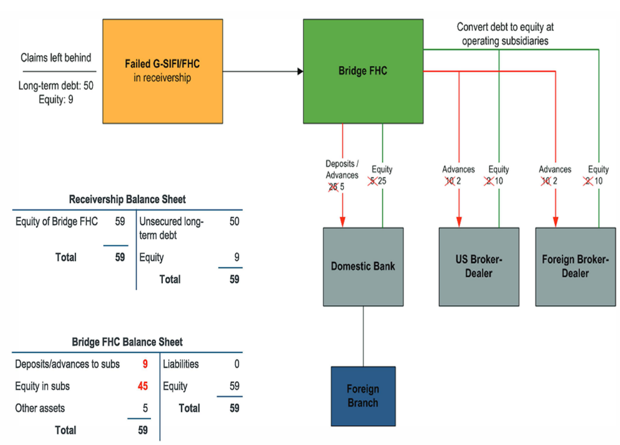


Under the SPOE recapitalization approach, a parent holding company that failed would be put into an FDIC receivership under OLA, which is similar to a proceeding under the Bankruptcy Code. Rather than immediately selling the firm or its assets to a third party, however, all of the firm's assets, including its ownership interests in and intercompany loans to its bank, broker-dealer and other operating subsidiaries, would be transferred to a newly established holding company called a ***bridge holding company*** (or bridge) over a weekend or even overnight.

The equity, long-term unsecured debt and other similar capital structure liabilities of the failed holding company would be left behind in the receivership. Any short-term unsecured debt, secured liabilities, financial contracts, guarantees of a subsidiary's financial contracts or other operating liabilities at the parent company level would be transferred to the bridge, if necessary to prevent contagion. It is rare, however, for secured liabilities or financial contracts to be booked at holding companies. Moreover, the holding company parents of G-SIFIs increasingly have very little, if any, commercial paper or other short-term debt at the holding company level, and the FDIC has the discretionary authority to make long-term debt legally subordinate to short-term debt. Finally, OLA contains a provision that overrides the early termination rights of counterparties on financial contracts booked at operating subsidiaries if those rights arise solely because of a failure of a parent holding company or an affiliate, as long as a creditworthy bridge financial company or third party assumes any parent or affiliate guarantees of those contracts within one business day after the parent's failure.

The FDIC is required to remove any directors and senior management responsible for the firm's failure, but it is free to include any other directors and senior management on the new bridge company's board of directors and senior management team.

Figure 4. SPOE Step 2: Recapitalizing Operating Subsidiaries



The business transferred to the bridge would be recapitalized as a result of leaving behind the long-term unsecured debt in the receivership. The FDIC would cause the bridge to recapitalize the operating subsidiaries by contributing its unconsolidated assets to any operating subsidiaries that need to be recapitalized. See Figure 4. One of the most common holding company assets is intercompany loans from the holding company to its operating subsidiaries. If there are enough such assets, the FDIC could cause the bridge to recapitalize the operating subsidiaries by forgiving such intercompany loans. For example, Figure 4 shows the bridge holding company forgiving $20 of the U.S. bank subsidiary's obligations on intercompany advances and deposits, resulting in an increase in the bank's capital of $20. If a subsidiary did not have enough intercompany debt for the bridge to forgive, the bridge could, subject to any regulatory requirements or limitations, contribute receivables from other subsidiaries to the troubled subsidiary since receivables would be assets on the bridge company's unconsolidated balance sheet. For example, if the U.S. bank subsidiary in Figure 4 did not have enough intercompany debt for the bridge to forgive, and the U.S. broker-dealer did not need additional capital, the bridge could contribute any receivables from the U.S. broker-dealer to the U.S. bank. This is because the receivable is an asset on the bridge's balance sheet and the bank would not be paying any purchase price for the contribution or assuming any liabilities in connection with the contribution.

In this manner, the FDIC could effectively cause any losses incurred at the operating subsidiary level to be pushed up to the failed holding company's receivership. The operating companies would therefore be recapitalized and kept out of insolvency proceedings without the use of any taxpayer money. The FDIC also might choose to cause the failed holding company to recapitalize the operating subsidiaries after the FDIC has been appointed receiver but before any assets are transferred to the bridge.

The bridge holding company with its recapitalized business and its recapitalized operating subsidiaries would open for business at the normal opening time on the day after resolution weekend or resolution night.

If the bridge holding company or any of its operating subsidiaries were unable to obtain enough liquidity from the market to fund their operations despite being recapitalized, the FDIC would use the OLF to provide them with temporary, fully secured liquidity at modestly above-market rates until the market stabilized. Once the market stabilized, the bridge and its operating subsidiaries should be able to obtain liquidity from the private sector and pay back the FDIC. Without such a temporary fully secured liquidity facility, the bank and other operating subsidiaries of the holding company would not be able continue to serve customers and clients, and the going concern value of the recapitalized group could be destroyed. If the group were forced to sell its otherwise valuable but illiquid assets for cash at fire-sale prices, it could destroy the franchise value of the otherwise well-capitalized bridge and foster the very sort of contagious panic that needs to be avoided to solve the too-big-to-fail problem.

From the point of view of averting contagion, certain features of a SPOE recap are critical. Specifically, the operating subsidiaries of the bridge holding company would be kept out of

receivership or insolvency proceedings and would open for business at the normal opening time on the day after resolution weekend or resolution night. All holders of any operating liabilities of the failed SIFI parent and its operating subsidiaries, including any depositors, would be paid in full in the ordinary course of business. The holding company's long-term, unsecured debt and other capital structure liabilities would be structurally subordinated to any debt at the operating subsidiary level, including any short-term, unsecured debt and comparable operating liabilities. In addition, to calm depositors and other short-term creditors and provide the markets with comfort regarding the safety and soundness of the recapitalized group, the OLF would be available to provide temporary, fully secured liquidity at modestly above-market rates to the bridge holding company and, indirectly, its operating subsidiaries until the group's liquidity stabilized. The going concern value of the recapitalized group would thus be preserved, and valuable but illiquid assets would not have to be sold for cash at fire-sale prices.

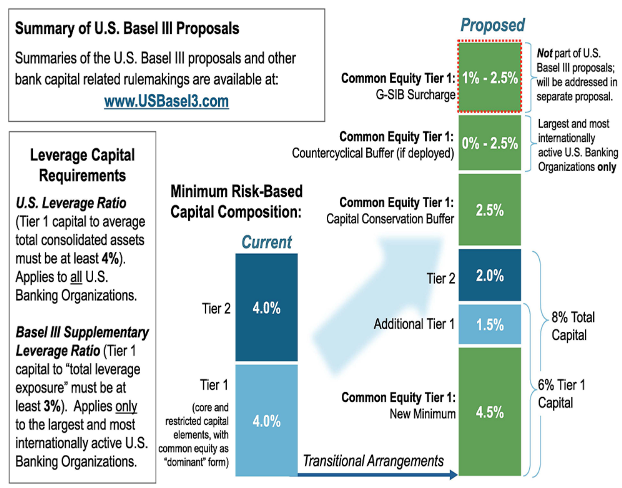
The distinction between ***capital*** and ***liquidity*** is critical. Under the law, the FDIC is only permitted to use the OLF to provide temporary fully secured liquidity to the bridge and its newly acquired operating subsidiaries, and not to provide capital to the failed parent, bridge or operating subsidiaries. New capital would be created solely by imposing losses on the holding company's creditors left behind in the receivership, and not by capital injections from the OLF. This distinction between prohibiting the OLF from being used to provide ***capital to absorb losses*** on the one hand, and allowing the OLF to be used to provide temporary ***secured liquidity*** to recapitalized bridge companies to stabilize the financial system on the other, is what distinguishes a taxpayer-funded bailout from traditional lender-of-last-resort facilities. The action of the government as lender-of-last-resort, including the Federal Reserve's discount window, has never been considered to be a taxpayer-funded bailout by the vast majority of observers, including such free market advocates as Milton Friedman, if the relevant lender-of-last-resort facilities satisfy the conditions of Bagehot's dictum.

Walter Bagehot in his classic 1873 book on central banking, defined the extension of credit under lender-of-last-resort-facilities such that it must only be made to solvent entities on a fully secured basis at above-market cost. If the OLF is used only as a temporary, fully secured ***liquidity facility*** that complies with the traditional safeguards for lender-of-last-resort facilities, it would ***not be a taxpayer bailout.***

Bagehot's solvency condition clearly would be satisfied in a SPOE recapitalization because the borrowers – the bridge and indirectly its new operating subsidiaries – would be more than solvent, having been recapitalized at generally applicable capital requirements, such as at fully phased in Basel III levels. When fully phased in, the U.S. version of Basel III will require banks and bank holding companies to have tangible common equity to risk-weighted assets of between 7 percent and 9.5 percent, depending on whether they are G-SIBs or G-SIFIs or not. See "Basel III" in the glossary contained in Annex B and as graphically illustrated in Figure 5. Taxpayers would be further insulated against any risk of loss by the fact that the statute requires the FDIC to recoup any losses that might nevertheless be

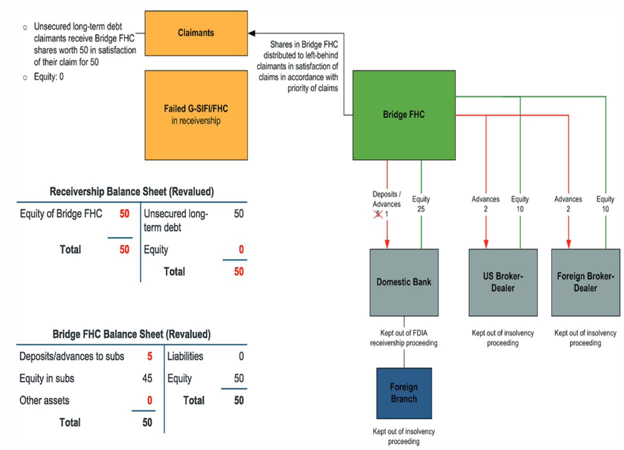
sustained by the OLF – for example by mistakes in valuing collateral – by imposing assessments on large, private-sector financial institutions.

Figure 5. U.S. Basel III Proposals



Source: Davis Polk & Wardwell LLP

Figure 6. SPOE Step 3: Distribution of Equity in Bridge FHC in Satisfaction of Claims Left Behind in Receivership



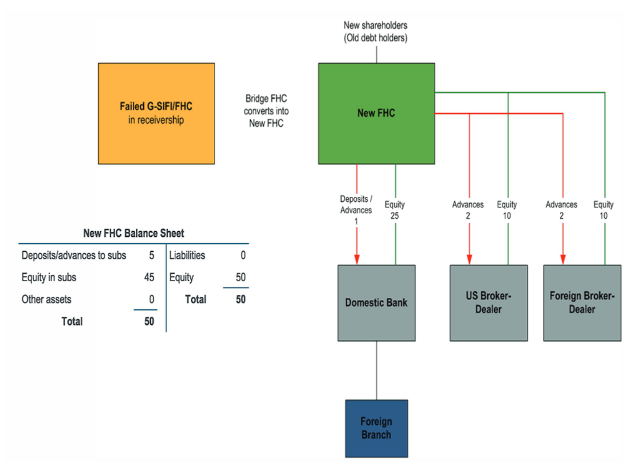
Receivership Balance Sheet (Revalued)

Equity of Bridge FHC	50	Unsecured long-term debt	50
Total	50	Equity	0
		Total	50

Bridge FHC Balance Sheet (Revalued)

Deposits/advances to subs	5	Liabilities	0
Equity in subs	45	Equity	50
Other assets	0	Total	50
Total	50		

Figure 7. SPOE Step 4: Termination of Bridge Status



New FHC Balance Sheet

Deposits/advances to subs	5	Liabilities	0
Equity in subs	45	Equity	50
Other assets	0	Total	50
Total	50		

After a normal claims process, the holders of the failed holding company's equity, long-term unsecured debt and other similar capital structure liabilities left behind in the receivership would receive all of the residual value of the recapitalized bridge holding company – that is, its equity – in satisfaction of their claims against the failed company in accordance with the predetermined priority-of-claims rules. At the same time, the bridge holding company would be converted into a normal state- or federally chartered corporation. See Figures 6 and 7. As a result, all of the group's losses would be borne by the failed parent holding company's equity, long-term unsecured debt holders and any other claimants left behind in the receivership, and not by taxpayers.

The failed holding company's combined equity, long-term unsecured debt and other similar capital structure liabilities would act as a shield against any losses by short-term creditors and the holders of other operating liabilities at the operating company level. As a result, using the SPOE strategy to recapitalize the group should, like deposit insurance, greatly reduce or even eliminate the incentive of the group's demand depositors, repo lenders, and holders of other money-like claims to run or for contagious runs to spread throughout the system. Using the OLF to provide interim liquidity to the bridge and its subsidiaries until confidence in the recapitalized group could be restored would further reduce the incentive to run.

A key to making this work is the distinction between capital structure liabilities, including long-term unsecured debt, and operating liabilities, including short-term debt. The reason for preferring short-term creditors and other holders of operating liabilities over long-term, unsecured creditors and other holders of capital structure liabilities is that they are not really similarly situated during a financial crisis. Short-term creditors and the holders of other operating liabilities have effectively bargained for the right to "run" during a financial crisis because they have the right to demand the return of their money or demand additional cash or liquid collateral immediately or within a very short period of time. They have also effectively paid for such rights, since the return on short-term debt and other operating liabilities is generally lower than the return on long-term debt and other capital structure liabilities of the same debtor.

By clearly making long-term, unsecured debt and other capital structure liabilities structurally or legally subordinate to the group's short-term debt and other operating liabilities in advance, the SPOE recap strategy signals to the market that these two types of liabilities are not similarly situated during a financial crisis and therefore will not be treated as if they were a single class. This signaling will result in efficient market pricing of long-term, unsecured debt and other capital structure liabilities, on the one hand, and short-term debt and other operating liabilities, on the other, thus eliminating any unfairness that might arise from a last-minute, unexpected discretionary decision to treat long-term, unsecured debt or other capital structure liabilities as subordinate to short-term unsecured debt and other operating liabilities.

The SPOE recap strategy is functionally equivalent to a high-speed reorganization of the failed parent holding company under Chapter 11 of the Bankruptcy Code, where the

essential features of the reorganization are completed over resolution weekend or even overnight. The going concern value of the systemically important and other viable part of the business is preserved, with the final distribution of value taking place at the end of the claims process. Most importantly the clients and customers of the operating subsidiaries will continue to be served without interruption.

While the FDIC is still working out the final details of this strategy, the FDIC's SPOE recap approach should solve the too-big-to-fail problem for SIFIs, including G-SIFIs, by providing a viable alternative to the unpalatable choice between bailout and the sort of contagious panic that can bring down the financial system if properly implemented. The essential conditions for this result to be achieved are as follows:

- ***Pre-Announced, Predictable and Viable Strategy***. The FDIC must publicly announce in a policy statement in advance of any particular SIFI's or G-SIFI's failure that it will use the SPOE recapitalization strategy to resolve certain types of SIFIs under OLA if invoked, so that the market and foreign regulators can rely on its public commitment to do so.
- ***Sufficient Loss-Absorbing Capacity***. The parent holding company of the SIFI has enough loss-absorbing capacity in its capital structure to immediately recapitalize its business if transferred to a bridge and all of its operating subsidiaries at whatever levels are generally required (e.g., fully phased-in Basel III levels), assuming the group suffers losses of some specified amount greater than those projected under the most severely adverse scenario used by the Federal Reserve in its most recent Comprehensive Capital Analysis and Review (CCAR) process.
- ***Structural or Legal Subordination***. The parent's equity, long-term unsecured debt, and other similar capital structure liabilities counted in its loss-absorbing capacity are either structurally subordinate to all material claims by the group's depositors, short-term creditors and other holders of operating liabilities, or the FDIC has publicly committed to exercise its discretionary authority to treat operating liabilities as if they were senior to capital structure liabilities.
- ***Secured Liquidity Facility.*** The OLF provides the bridge holding company with access to temporary, fully secured liquidity that is secured by any of its assets or those of its subsidiaries that are pledged or repledged to the OLF in an amount equal to the fair market value of such assets less reasonable haircuts.

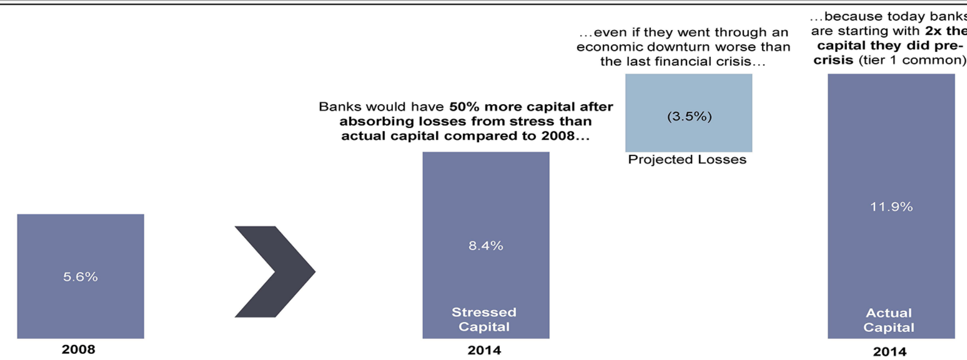
This report also recommends that the FDIC have the option of distributing the residual value of the resolved SIFI among the claimants left behind in the receivership based on ***relative priority***. This will minimize valuation disputes, reduce the risk of legitimate claims based on violations of constitutionally protected property rights, and effectively mirror the distributions produced by "***bail-in"*** proposals currently being considered in Europe.

Exhibit B

Increased Capital

Banks have more ***stressed*** capital today than they had ***actual*** capital in August 2008

Banks have higher capital today in a stressed environment than actual capital in August 2008…



…making them more resilient against insolvency…

…which has been noted by regulators: Quotes from Fed Chairs Janet Yellen and Ben Bernanke

- "From **early 2009 through 2014, capital held** by the eight most systemically important U.S. bank holding companies **more than doubled, reflecting an increase of almost $500 billion** in the strongest form of capital held by these companies" – Janet Yellen
- "Even under the severely adverse scenario of the latest stress test, **the estimate of these firms' post-stress tier 1 common capital ratio is more than 2 percentage points higher than actual capital levels at the end of 2008**." – Ben Bernanke

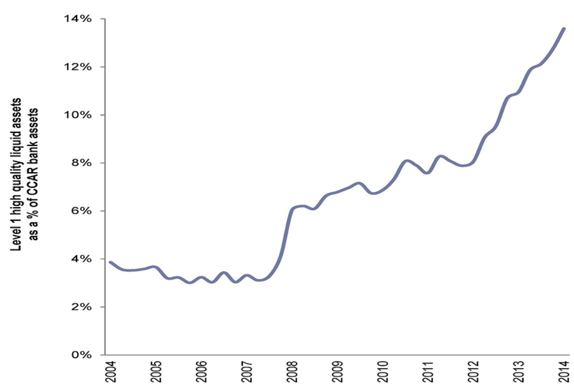
Note: Actual and stressed tier 1 capital ratios reflective of CCAR banks in 2015 DFAST stress test
Source: *Federal Reserve, SNL Financial.*

Exhibit C

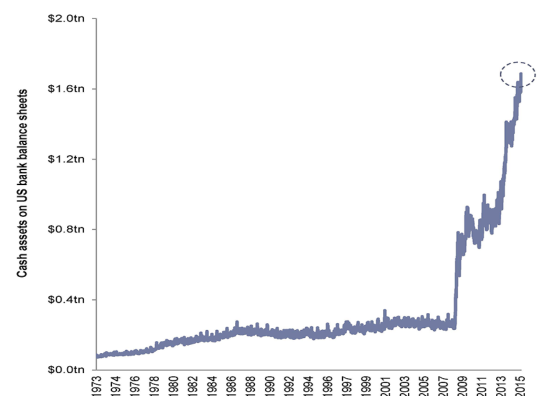
Increased Liquidity:
More Cash and HQLAs

Banks also have significantly more liquid balance sheets, making them more resilient against runs and contagion

Banks have more than 3 times the amount of high-quality liquid assets compared to 2008…



…and cash assets in the U.S. banking system are now more than 5 times their 2008 level



…which has been noted by regulators: Quote from Fed Chair Janet Yellen

- "Likewise, the Federal Reserve's increased focus on liquidity has contributed to significant increases in firms' liquidity. The **high-quality liquid assets** held by [the] eight [U.S. G-SIB] firms **has increased by roughly one-third since 2012**, and their **reliance on short-term wholesale funding has dropped considerably**." – Janet Yellen

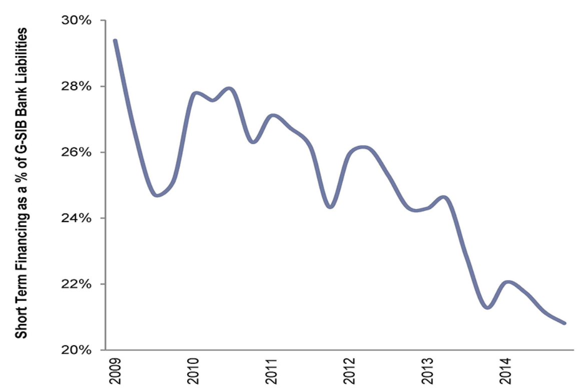
Note: Level 1 HQLA defined as cash, U.S. Treasuries, and GNMA RMBS. Left chart reflects all CCAR banks; right chart reflects U.S. domestic banks.
Source*: SNL Financial, Regulatory Filings, Federal Reserve*

Exhibit D

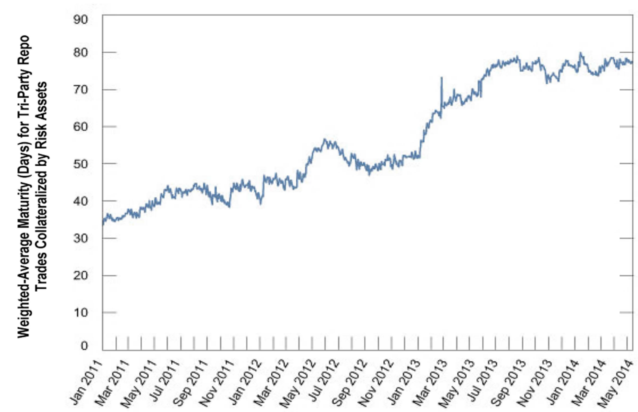
**Increased Liquidity:
Reduced Reliance on Short-Term Wholesale Funding**

Banks have also reduced their reliance on short-term wholesale funding, making them more resilient against runs and contagion

Banks have significantly lowered their reliance on short-term wholesale funding…



…and pushed out the duration of any remaining short-term wholesale funding



Note: Left chart, short term financing defined as commercial paper, trading liabilities, <1 yr borrowings, repurchase agreements, reflective of all U.S. G-SIBs.
Source: *SNL Financial, Regulatory Filings, FRBNY, Liberty Street Economics' Paper "What's Your WAM? Taking Stock of Dealers' Funding Durability" published 6/9/2014*

Exhibit E

U.S Regulatory Standards

Stronger U.S. regulatory standards increase with size and complexity of U.S. banks…

Regulation	Less than $10bn assets	$10-$50bn	$50-$250bn	>$250 (not G-SIBs)	U.S. G-SIBs
Recovery Plans					✓
TLAC Requirement					✓
G-SIB Capital Surcharges					✓
Supplementary Leverage Ratio (5% / 6% requirement)[(1)]					✓
AOCI included in Basel 3 capital				✓	✓
Full Liquidity Coverage Ratio				✓	✓
Supplementary Leverage Ratio (3% requirement)				✓	✓
Advanced Approach RWA				✓	✓
Resolution Plans			✓	✓	✓
Early Remediation Tools			✓	✓	✓
Modified Liquidity Coverage Ratio			✓	✓	✓
Annual Fed-run Capital Plan and Stress Test			✓	✓	✓
Annual Company-run Stress Test		✓	✓	✓	✓
Durbin (interchange) Amendment		✓	✓	✓	✓
Subject to Regulation by CFPB	Certain Products	✓	✓	✓	✓
Prompt Corrective Action Tools	✓	✓	✓	✓	✓
Volcker Rule	✓	✓	✓	✓	✓

(1) 5% requirement at the holding company, 6% at insured depository institutions

Source: *Federal Reserve, FDIC.*

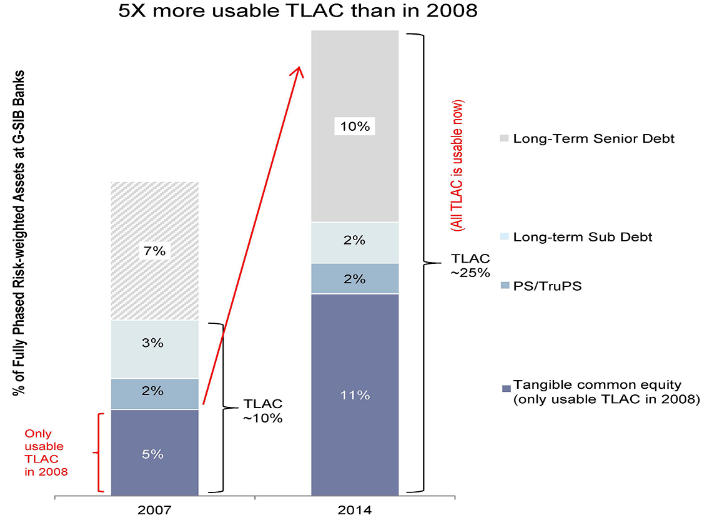
Exhibit F

Increased Usable TLAC

Usable TLAC: The most important structural change that most people have never heard of . . .

U.S. G-SIBs have substantially increased and restructured their equity and long-term unsecured debt so that all of it can now be used to absorb losses without threatening financial stability

5X more usable TLAC than in 2008



Note: TLAC estimate reflects all U.S. G-SIBs.
Source: *Federal Reserve, SNL Financial, Regulatory Filings.*

- Total loss-absorbing capacity (TLAC) consists of equity plus long-term unsecured debt that can be converted to common equity in bankruptcy
- In 2008, long-term senior debt not usable without causing contagion; could not legally impose losses on senior debt without doing so on short-term debt
- Even subordinated debt, preferred stock and trust preferred securities (TruPS) unusable in 2008 because market confusion about loss waterfall
- U.S. G-SIBs have restructured themselves to make long-term senior debt structurally subordinate to short-term debt
- Long-term senior debt can now be converted to common equity without converting short-term debt or causing contagion or financial instability
- U.S. G-SIBs now have **5X more usable TLAC** than in 2008
- No more market confusion about loss waterfall
- Enough TLAC to recapitalize U.S. G-SIBs at full Basel III capital levels under conditions twice as severe as 2008 financial crisis

Exhibit G

Increased Usable TLAC:
Reaction of Markets and Regulators

Both market and regulators expect this structural change to make U.S. G-SIBs more resolvable under the Bankruptcy Code

During 2008 financial crisis, market expected both long-term debt and short-term debt of U.S. G-SIBs to be bailed out because losses could not be imposed on long-term debt without imposing losses pro rata on short-term debt, which would have fostered contagion and threatened financial stability

- Moody's has eliminated uplift on ratings of U.S. G-SIBs from expected government support, because government bailouts no longer expected
- S&P expects to remove such uplift soon
- No more market confusion about loss waterfall
- Market understands that long-term unsecured debt will act as a private-sector buffer against losses by short-term unsecured debt
- Spreads on long-term debt of U.S. G-SIBs are now higher than spreads on long-term debt of other U.S. banks
- Current amount of usable TLAC should make SPoE and other resolution strategies feasible under ordinary bankruptcy laws
- FSB has issued minimum TLAC proposal
- Fed has indicated it plans to issue "gold-plated" TLAC proposal for U.S. G-SIBs

"Rather than relying on public funds to bail-out one of [the U.S. G-SIBs], we expect that bank holding company creditors will be bailed-in and thereby shoulder much of the burden to help recapitalize a failing bank."

- Robert Young, Moody's Managing Director (April 2013)

"[S]uccessful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of a substantial tranche of long-term unsecured debt that is subject to bail-in during a resolution and is structurally subordinated to the firm's other creditors should reduce run risk by clarifying the position of those other creditors in an orderly liquidation process."

- Fed Governor Tarullo (Senate Testimony, September 2014)

"[I]t is notable that, at present, large U.S. firms have substantial amounts of long-term debt on their balance sheets."

- Fed Governor Tarullo (December 2012)

Exhibit H

ISDA Resolution Stay Protocol

U.S. G-SIBs have also taken significant actions to address early termination issues in financial contracts

ISDA Protocol and Regulations

- 6 of 8 U.S. G-SIBs are among 18 G-SIBs adhering to new ISDA Stay Protocol
- Protocol imposes temporary stay on direct defaults and overrides cross-defaults in existing and future ISDA contracts among 18 G-SIBs
- ISDA Protocol is being reflected in all new financial contracts
- Support regulations to expand principles of ISDA Protocol to more counterparties and financial contracts
- No similar mechanism existed during the 2008 crisis

Eliminate Impediment to Resolution

- Overriding cross-defaults prevents liquidity runs when parent fails but direct counterparty operating subsidiary is still performing on financial contracts
- Temporary stay gives bankruptcy courts more time to avoid value destruction from early termination without undermining risk management function of financial contracts
- Pause in the collection of swaps collateral could give U.S. G-SIBs enough time to re-capitalize and avoid the kind of panic that followed the 2008 failure of Lehman Brothers

"This is a major achievement, by the industry….With the adoption of the protocol by the top 18 dealer G-SIBs in November, over 90% of their OTC bilateral trading activity will be covered by stays of either a contractual or statutory nature."

- Financial Stability Board, Press Release (October 2014)

"This initiative is an important step toward mitigating the financial stability risks associated with the early termination of bilateral, OTC derivatives contracts triggered by the failure of a global banking firm with significant cross-border derivatives activities."

- Federal Reserve Board and FDIC Joint Press Release (October 2014)

Exhibit I

Recognized Progress in Improving Resolvability

The regulators have recognized the progress the U.S. G-SIBs have made in improving their resolvability

"I would suggest that there has been no greater or more important regulatory challenge in the aftermath of the financial crisis than **developing the capability for the orderly failure of a systemically important financial institution**. While there is still a lot of work to do, looking at where we were and where we are today, in my view **the progress has been impressive**…

"While there is still much work to do, if there is one point I would like to conclude with today it is that there has been a **transformational change** in the United States and internationally since the financial crisis in regard to the resolution of systemically important financial institutions that perhaps has been **underappreciated**."

- FDIC Chairman Gruenberg (May 2015)

"Work on the use of the resolution mechanisms set out in the Dodd-Frank Act, based on the principle of a single point of entry … holds the **promise of making it possible** to resolve banks in difficulty **at no direct cost** to the taxpayer.

"**[C]onsiderable progress** has been made … in developing suitable resolution regimes for financial institutions"

- Fed Vice Chairman Fischer (August 2014)

"My view is that those steps have made the system **safer, sounder and more resilient**—and by a wide margin. It's frankly hard to overestimate the impact of Dodd-Frank. The Volcker Rule, the Financial Stability Oversight Council, risk retention, enhanced resolution authority—these and a dozen other important provisions of that historic law laid the groundwork for a **safer** and **more stable financial system**."

- Comptroller of the Currency Curry (June 2015)

"[W]e established a set of enhanced standards for large U.S. banking organizations to **help increase the resiliency** of their operations and thus promote financial stability. … These and other measures have already created a financial regulatory architecture that is **much stronger and much more focused on financial stability** than the framework in existence at the advent of the financial crisis."

- Fed Governor Tarullo (September 2014)

"The **single-point-of-entry** approach offers the **best potential** for the orderly resolution of a systemic firm …, in part because of its potential to mitigate run risks and credibly impose losses on parent holding company creditors and, thereby, to enhance market discipline."

- Fed Governor Tarullo (October 2013)

PREPARED STATEMENT OF JOHN B. TAYLOR

HOOVER INSTITUTION SENIOR FELLOW IN ECONOMICS, STANFORD UNIVERSITY

JULY 29, 2015

Chairman Toomey, Ranking Member Merkley, and other Members of the Subcommittee on Financial Institutions and Consumer Protection, I thank you for the opportunity to testify at this important hearing on "The Role of Bankruptcy Reform in Addressing Too Big To Fail". [1]

Bankruptcy reform is essential to addressing the problem of too big to fail. A well-designed reform that handles large financial firms and makes failure feasible under clear rules without disruptive spillovers would greatly reduce the likelihood of Government bailouts. It would thereby diminish excessive risk-taking, remove uncertainty due to an inherently ad hoc bailout process, and cut the implicit subsidy to "too big to fail" firms.

In the 7 years since the financial crisis, much economic research and legal analysis has been devoted to finding the best way to proceed with bankruptcy reform. [2] And good reform bills have now been introduced in the Senate, "The Taxpayer Protection and Responsible Resolution Act" (TPRRA) and in the House, "The Financial Institution Bankruptcy Act of 2015".

Current Bankruptcy Law and the Failure of Large, Complex Financial Institutions

Under current bankruptcy law, a failing firm can be reorganized under a Chapter 11 proceeding in which losses are calculated according to prescribed and open procedures, known in advance. If the failed firm's liabilities exceed its assets, then the shareholders are wiped out. The remaining difference between liabilities and assets is then allocated among creditors in the order of priority stipulated by the law, which is also known in advance. The creditors' debts are written down and, sometimes, converted into equity in the reorganized firm. In the end, the firm continues in business with either the old or new managers. Chapter 11 ensures that creditors bear losses and this reduces moral hazard and excessive risk-taking.

Thus, Chapter 11 has many benefits. However, Chapter 11 is designed as a general procedure for a wide variety of businesses. Large complex financial institutions present special considerations which warrant a reform of the bankruptcy code. The existing bankruptcy process is likely to be too slow for the fast moving markets that these types of firms deal in. The bankruptcy judges might not have enough financial experience to understand the market implications of their judicial decisions. Many exceptions to bankruptcy (for example, for brokerage and insurance companies) also complicate Chapter 11 proceedings for large multiproduct financial firms.

Perhaps most importantly, under Chapter 11 it is difficult to maintain adequately the operations of a large complex financial institution that is failing in ways that will prevent a run. Because of Government policymakers' concerns about the systemic consequences of such a run, use either Title II of the Dodd-Frank Act or a direct bailout.

Concerns over the experience with Lehman Brothers' Chapter 11 may make it more likely in the future that creditors would run before a Chapter 11 proceeding and that policymakers would therefore resort to Title II or a bailout. In the case of Lehman, losses were allocated to short-term unsecured creditors that had continued to fund Lehman because they expected its treatment to be similar to Bear Stearns' bailout. Even if these concerns are unwarranted, they lead market participants to expect that Chapter 11 will not be used.

Bankruptcy Reform for More Credible Resolutions Through Bankruptcy Law

To deal with these shortcomings, a reform of the bankruptcy code is needed with a new chapter or subchapters along the lines of the Chapter 14 proposal in the Tax-

[1] Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution, and former Under Secretary of Treasury for International Affairs, 2001–2005. I am most grateful to Emily Kapur for advice and suggestions in preparing this testimony which draws directly from her research on how a Chapter 14 reform of the bankruptcy code would work in practice.

[2] See, for example, the work of the Resolution Project at Stanford University's Hoover Institution in the books by Scott, Jackson, and Taylor (2015), Scott and Taylor (2012), Scott, Shultz, and Taylor (2010), the Bipartisan Policy Center report by Jackson, Guynn, and Bovenzi (2013), the Cleveland Fed study by Fitzpatrick and Thomson (2011), the Board of Governors of the Federal Reserve (2011), and Government Accountability Office (2011).

payer Protection and Responsible Resolution Act[3] or the Subchapter V of Chapter 11 proposal in the Financial Institution Bankruptcy Act of 2015. Under such a reform the procedures to determine asset values, liabilities, sales of some lines of business, write-downs of claims, and recapitalization would be based on the rule of law, as under Chapter 11, and the strict priority rules of bankruptcy would govern. Thus, the resolution regime under bankruptcy would ensure that any failing institution would be resolved through the same known set of processes. One of the biggest problems in the 2008 panic was a lack of predictability, with the Government applying widely varying policies.

Unlike reorganization under Chapter 11, however, the Chapter 14 proceedings would be overseen by a specialized panel of Article III judges and special masters with financial expertise. The bankruptcy would involve only a single proceeding, unlike current law where a parent company must go through one proceeding and insurance and brokerage subsidiaries through another, adding considerable complexity.

Chapter 14 would operate faster—ideally over a weekend—and with no less precision than Chapter 11. Unlike Chapter 11, it would leave all operating subsidiaries outside of bankruptcy entirely. It would do this by moving the original financial firm's operations to a new bridge company that is not in bankruptcy. This bridge company would be recapitalized by leaving behind long-term unsecured debt—called the "capital structure debt." The firm's long-term unsecured debt would bear the losses due to the firm's insolvency and any other costs associated with bankruptcy. If the amount of long-term debt and subordinated debt were sufficient, short-term lenders would not have an incentive to run, and the expectation of Chapter 14's use will reduce ex ante uncertainty about runs.

The goal of these provisions is to let a failing financial firm go into bankruptcy in a predictable, rules-based manner without causing disruptive spillovers in the economy while permitting people to continue to use its financial services without running. The net effect is similar to well-known bankruptcy cases for nonfinancial firms in which people could continue to fly on American Airlines planes, buy Kmart sundries and try on Hartmax suits. The provisions make it possible to create a new fully capitalized entity which would credibly provide most of the financial services the failed firm was providing before it got into trouble. Modularization of the firm, which is in principle made easier by the living wills, would expedite the process.

The new Chapter 14 would also allow the primary Federal regulator of the firm to file a bankruptcy petition in addition to creditors and management. This would expedite the process, especially in cases where management, fearing a loss of equity or employment, has incentives to put off a filing. The examiner's report on Lehman makes it very clear there was no preparation for bankruptcy proceedings before the bankruptcy filing, which increased the size of the disruption.

To understand how such a reformed bankruptcy code would resolve a large and complex financial institution, it is very useful to consider how Chapter 14 would have worked in the case of Lehman Brothers in 2008. Emily Kapur (2015) has carefully researched such a scenario using balance sheet and financial data that has been made public through Lehman's court proceedings, and has prepared a brief and illustrative summary which appears at the end of this testimony.

Bankruptcy Reform and More Robust Resolution Planning Under the Dodd-Frank Act

The Dodd-Frank Act requires that resolution plans—living wills—be submitted by the large and complex financial firms to show how these firms can be resolved in cases of distress or failure in a rapid and orderly resolution without systemic spillovers under existing law. Of course, existing law includes Chapter 11 of the bankruptcy code.

Thus far the plans submitted by the large financial firms have been rejected by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). The reasons for the rejections are not fully known, but clearly the requirement that the firms would have to go through a Chapter 11 bankruptcy is an impediment as I explained in the first section of this testimony: it is very difficult, if not impossible, at this time to bring one of these large firms through a conventional Chapter 11 bankruptcy.

William Kroener (2015) points out, however, that a Chapter 14 reform would greatly facilitate the resolutions plans' ability to meet the statutory requirements.

[3] After first using the term Chapter 11F in Scott, Shultz, and Taylor (2010), the Resolution Project at Stanford's Hoover Institution adopted the term Chapter 14 in Scott and Taylor (2012) because there is currently no such numbered chapter in the code. Here I use the term Chapter 14 to refer to this type of bankruptcy reform.

Unlike Chapter 11, it would leave all operating subsidiaries outside of bankruptcy entirely as these subsidiaries move to the new firm that is not in bankruptcy. In other words, bankruptcy reform would help greatly in the resolution planning process required in the Dodd-Frank Act.

Shortcomings of the FDIC Resolution Mechanism Under Title II of the Dodd-Frank Act

While full liquidation with wiped-out shareholders was a major selling point of the Dodd-Frank Act,[4] in the years since the Act was passed the focus of the FDIC has been on how to resolve and reorganize the failing firm into an ongoing concern, rather than on how to liquidate it. To achieve such a re-organization under this new authority the FDIC would transfer part of a failing firm's balance sheet and its operations to a new bridge institution.

In order to carry out this task, the FDIC would have to exercise considerable discretion. The degree of discretion would be especially large in comparison with more transparent and less uncertain bankruptcy proceedings through which nonfinancial firms are regularly resolved and reorganized through the rules of the bankruptcy laws. As a result there is confusion about how the reorganization process would operate under Title II, especially in the case of international firms. Indeed, this uncertainty about the Title II process would likely lead policymakers to ignore it in the heat of a crisis and resort to massive taxpayer bailouts as in the past. Hence, the concern about bailouts remains.

But even if the Title II process were used, bailouts would be likely. As the FDIC exercised its discretion to form a bridge bank, it would likely give some creditors more funds than they would have expected or been entitled to under bankruptcy law. They might wish to hold some creditors harmless, or nearly harmless, in order to prevent a perceived contagion of the firm's failure to other parts of the financial system. This action would violate the priority rules that underlie everyday decisions about borrowing and lending. Under the reasonable definition that bailout means that some creditors get more than they would under bankruptcy laws or under the normal workings of the market, such action would, by definition, be a bailout of the favored creditors.

This expectation of bailout of some creditors increases the risk of financial instability. Government regulation through capital or liquidity requirements and supervision is not the only way a financial firm's risk-taking decisions are constrained. Discipline is also imposed on the firm by its counterparties, so long as they perceive a need to monitor the firm and protect themselves from losses by demanding collateral or simply cutting off credit. Creditors have significant advantages over Government regulators, in terms of current knowledge, ability to act quickly, and financial stakes. And they are not subject to regulatory capture.

The expectation of bailouts of creditors weakens the incentives for them to monitor their loans and thereby provide this constraint on risk taking. Because the bailout reduces the risk incurred by large creditors expecting to be favored, they charge a lower interest rate, creating the subsidy of large and complex financial firms.

It is important to recognize that the perverse effects of such bailouts occur whether or not the source of the extra payment comes from the Treasury financed by taxpayers, from an assessment fund financed by financial institutions and their customers, or from smaller payments for less favored creditors.

Contrasting the resolution of a failing financial firm under Title II with resolution under a reformed bankruptcy procedure reveals additional concerns with Title II. Under bankruptcy reorganization, private parties, motivated and incentivized by profit and loss considerations, make key decisions about the direction of the new firm, perhaps subject to bankruptcy court oversight. But under Title II a Government agency, the FDIC and its bridge bank, would make the decisions. This creates the possibility that the FDIC would be pressured to ask the bridge firm to grant special favors to certain creditors as in the case of the Government Sponsored Enterprises.

In addition, the resolution of a firm through a Government-administered bridge company could give the new firm advantages over its competitors in comparison with a bankruptcy resolution. The Treasury is authorized to fund the FDIC which can fund the bridge firm, creating a subsidy, and under Title II the bridge firm can be given lower capital requirements and forgiven tax liabilities.

One can understand that the FDIC or any Government agency in charge of resolutions would want to use such legal provisions to nurse the bridge firm with special advantages for a while before letting it compete on a level playing field. But with a large amount of discretion and strong incentives to make the resolved firm a suc-

[4] This section is based on Taylor (2013).

cess, there is a concern that the advantages granted by a Government agency could become excessive and prolonged.

Summary

In this testimony I showed why a reform of the bankruptcy law along the lines of the Senate bill, "The Taxpayer Protection and Responsible Resolution Act" (TPRRA) or the House bill, "The Financial Institution Bankruptcy Act of 2015" is essential for ending Government bailouts as we know them. Such a reform—which would make failure feasible even for large and complex financial institutions—would play a key role in addressing the problems of excess risk taking, uncertainty, and unfair subsidies associated with too big to fail, which persist under the Dodd-Frank Act. If accompanied with an increase in capital and capital structure debt, such a reform would go a long way toward ending too big too fail.

If Title II of the Dodd-Frank Act remains in the law, such a reform would likely reduce the use of Title II, and thus lead to more rules-based and less discretionary resolutions. The reform would also repair the resolution planning process now required under the Dodd-Frank Act.

A Lehman Brothers Scenario under Chapter 14, by Emily Kapur, Stanford University

Lehman Brothers, like most of its peers, had a holding company at the top, called Lehman Brothers Holdings Inc., which owned thousands of subsidiaries. These included its New York based broker-dealer Lehman Brothers Inc., or LBI, and its London based broker-dealer Lehman Brothers International Europe, or LBIE. Lehman was involved in many businesses including securities trading, over-the-counter derivatives, prime brokerage, and even commercial banking. But it was Lehman's real-estate-related activities that got it into trouble. No one knows quite how substantial its losses were, but they almost certainly wiped out Lehman's book equity. Researchers have estimated that they exceeded equity by between $10 and $40 billion.[5]

Lehman's problems had been mounting for months but came to a head in early September 2008. At that point, markets still perceived Lehman to be solvent, but thought its assets were worth only $2 billion more than its liabilities. Internally, Lehman was preparing to announce third quarter losses that would be $2 billion more than markets had predicted. Thus, there was every reason to expect this announcement to eliminate markets' perceptions that Lehman was solvent. Sure enough, once Lehman announced its third quarter losses and conceded that its efforts to raise additional capital had failed, creditors and counterparties ran. The firm lost $30 billion of liquidity over a week as repurchase agreement lenders pulled funding, prime brokerage clients withdrew accounts, and derivatives counterparties and clearing banks demanded additional collateral. Entirely out of cash with which to continue operations, on September 15, 2008 Lehman Brothers filed the largest Chapter 11 case in U.S. history.

Importantly, Lehman owed about $100 billion in subordinated and long-term debt upon its demise, far more than any estimate of its excess losses from real estate. This combined with

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[5] See Kapur (2015) for references for these and figures cited below

the fact that its liquidity problems were foreseeable make Lehman's the type of case that Chapter 14 would be best structured to address.

To illustrate the process that Chapter 14 would facilitate, consider a hypothetical counterfactual case for Lehman Brothers. Imagine Lehman fails in the market environment of 2008 with the same information, balance sheets, contractual relationships, and operational systems that it had then. But this time, the legal and regulatory environment is different. Both Dodd-Frank and Chapter 14 are in force in the U.S., and thus the Federal Reserve is Lehman's primary regulator. Internationally, banks have implemented the contractual reforms that ISDA has recommended and European authorities have implemented the Bank Resolution and Recovery Directive.

In this environment, the weekend before Lehman planned to announce its third quarter losses, the Fed determines it is time for Lehman to undergo Chapter 14. There is every reason to expect Chapter 14 to prevent any systemic consequences. Consequently, Title II is foreclosed by its own terms, because it cannot be used if bankruptcy will work.

On a Friday evening, say September 5, the week before Lehman actually filed, the Fed files a Chapter 14 case on behalf of Lehman Holdings. The filing triggers an expanded automatic stay and other bankruptcy rules. Importantly, this case is only for Holdings. All of its subsidiaries, including both LBI and LBIE, remain outside of the bankruptcy proceeding and the expanded stay safeguards their operations.

Upon filing, the Fed makes a motion to sell all of Holdings' assets and all liabilities except the $100 billion of subordinated and long-term debt. The purchaser is a non-bankrupt company called New Holdings whose equity the bankruptcy estate will own. The Fed sends notice to Lehman's largest creditors and to the regulators of its subsidiaries that parties may raise

objections at a hearing scheduled for Saturday evening. Though the timeframe is short, Lehman has worked previously with these parties to develop a living will focused on a Chapter 14 proceeding, so no one is caught by surprise. The court must conclude the hearing by Sunday, but need make only cursory findings based upon the Fed's filings. The structure of the hearing strikes a balance: on the one hand offering parties an opportunity to be heard, especially on issues pertaining to management of the new company, while on the other ensuring that the process moves along quickly enough to prevent systemic effects.

On Sunday, the court approves the transfer. New Holdings now exists entirely outside the bankruptcy system. It is managed by private-sector individuals chosen for their ability to maximize value for Holdings' single owner, the bankruptcy estate. New Holdings owns all assets previously owned by Holdings, including all of Lehman's subsidiaries. The subsidiaries themselves have not gone through bankruptcy and various bankruptcy code provisions have prevented adverse effects from the parent company's filing. New Holdings has also assumed most of Holdings' liabilities, but not the $100 billion of subordinated and long-term debt. Thus, short-term lenders can expect to be paid on time. Moreover, New Holdings' capital ratio is nearly four times that of Holdings, because it shed so much debt.

In the end, then, the bankruptcy proceeding makes clear to markets that, even after recognizing its real estate losses, the company headed by New Holdings—call it New Lehman—is exceedingly well capitalized for a financial firm, with a capital ratio of 10 to 15% depending on the extent of the write-downs. By the time markets open in Asia on Monday morning, LBI and LBIE are able to continue to provide key financial services and there is no reason for creditors to run. Furthermore, because the proceeding was undertaken in a timely manner, New Lehman can withstand a moderate drain on liquidity as markets adjust to its new structure.

In contrast to markets' chaotic response to Lehman's Chapter 11 filing, their response to a Chapter 14 filing is quite sober. There is no reason for investors to run on money market funds and no reason for those funds to curtail lending to corporations. Hedge funds do not flee so readily from prime brokers and investment banks are less crunched for liquidity and less likely to turn to the Fed for financing. Ultimately, there is less of a need for legislation to inject hundreds of billions of dollars into the financial system.

Eventually, New Lehman makes a public offering of stock in order to value the bankruptcy estate's ownership interest. The estate then follows the standard bankruptcy priority requirements to distribute its assets and close up shop. There are only three classes of claimants: long-term debt holders, subordinated debt holders, and shareholders. Most likely, the valuation indicates that there are only enough funds to pay back the long-term debt holders in part. Subordinated debt holders and shareholders are wiped out. All other creditors are creditors of New Lehman and not of the bankruptcy estate and so are paid in full at maturity.

In the end, if Lehman went through Chapter 14, shareholders and subordinated debt holders would make out the same as in Lehman's Chapter 11 case—getting nothing—and everyone else would do better, reducing the overall losses by hundreds of billions of dollars. Consequently, risks of systemic effects would be minimized both because the quick proceeding would allow the firm to continue operating and because all parties would expect lower losses. Nonetheless, unlike in a bailout, a substantial proportion of creditors would come away from the process convinced that the possibility of sustaining losses was a real one. And the procedure would demonstrate that even a Lehman Brothers-type firm is not too big to fail.

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PREPARED STATEMENT OF THOMAS H. JACKSON

PRESIDENT EMERITUS, UNIVERSITY OF ROCHESTER

JULY 29, 2015

Thank you for inviting me to testify today. I am Thomas Jackson, Distinguished University Professor and President Emeritus at the University of Rochester. Prior to moving to the University of Rochester, I was a professor of law, specializing in bankruptcy, at Stanford, Harvard, and the University of Virginia schools of law. I am the author of a Harvard Press book, *The Logic and Limits of Bankruptcy Law,* a bankruptcy casebook, and numerous articles on bankruptcy law. Recently, my work in the field of bankruptcy has focused on the use of bankruptcy in resolving systemically important financial institutions (SIFIs). In that capacity, I was cochair of a Bipartisan Policy Center working group that produced, in May of 2013, *Too Big To Fail: The Path to a Solution.* I have also been, since 2008, a member of the Hoover Institution's Resolution Project, which has produced three books discussing how bankruptcy can be made more effective in terms of the resolution of SIFIs (the most recent one, *Making Failure Feasible,* is in the final publication process). And, since 2013, I have been a member of the Federal Deposit Insurance Corporation's (FDIC's) Systemic Resolution Advisory Committee. I am here today in my individual capacity, and the views I express are my own, not those of any group or organization with which I am affiliated.

I am a firm believer that the Bankruptcy Code, with a few significant changes, can be made an important player in the resolution of SIFIs and that both bankruptcy law and the Dodd-Frank Act can be made more effective as a result. Before discussing those changes, however, I believe it is important to set out, briefly, (a) the relationship envisioned between the Dodd-Frank Act and bankruptcy law, (b) the current status of the major alternative to bankruptcy—the Orderly Liquidation Authority (OLA) of Title II of the Dodd-Frank Act, (c) why bankruptcy law, without statutory changes, is likely to be inadequate in terms of fulfilling what virtually everyone believes should be its role, and (d) why this creates problems both for the Dodd-Frank Act's Title I provisions for resolution plans under Section 165(d)—so-called "Living Wills"—as well as for its OLA provisions under Title II. After setting out that important backdrop, I will discuss, at a somewhat abstract level, the core of changes that I would suggest be implemented in the Bankruptcy Code in order to make it the primary resolution mechanism, even in light of the FDIC's development of "single-point-of-entry" (SPoE) as its presumptive method of implementing OLA under Title II of the Dodd-Frank Act, thus fulfilling the intent of both Title I and Title II of that Act. A full set of changes I might recommend—including provisions that might be "nice but not necessary"—is discussed in my contribution to *Making Failure Feasible,* a copy of which is attached to this Statement as an Appendix.

The Relationship Envisioned Between the Dodd-Frank Act and Bankruptcy Law

In two key places, the Dodd-Frank Act envisions bankruptcy as the preferred mechanism for the resolution of SIFIs. The first occurs in Title I, with the provision for resolution plans under Section 165(d). Covered financial institutions are required to prepare, for review by the Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB), the Financial Stability Oversight Council, and the FDIC, "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure . . . ."[1] If the Federal Reserve Board and the FDIC jointly determine that a submitted resolution plan "is not credible or would not facilitate an orderly resolution of the company under Title 11, United States Code" (i.e., the Bankruptcy Code), the company needs to resubmit a plan "with revisions demonstrating that the plan is credible, and would result in an orderly resolution under title 11, United States Code . . . ."[2] The failure to submit a plan that meets these tests can lead to restrictions, and divestiture, "in order to facilitate an orderly resolution of such company under title 11, United States Code . . . ."[3] For present purposes, the important point is that effective resolution plans are tested against bankruptcy law, not OLA under Title II of the Dodd-Frank Act. It therefore goes without saying—but is worth saying nonetheless—that the effectiveness of

[1] Dodd-Frank Act §165(d)(1).
[2] Dodd-Frank Act, §165(d)(4)
[3] Dodd-Frank Act, §165(d)(5)(A) and (B).

bankruptcy law in being able to resolve SIFIs is critically important to the development of credible resolution plans under Title I.[4]

Indeed, first-round resolution plans were uniformly rejected as inadequate. The eight U.S. Global Systemically Important Banks (G–SIBs) filed revised plans within the past month; most of them propose a SPoE resolution strategy, keyed off of the FDIC's work for resolution under the Dodd-Frank Act's Title II OLA, and which, in my view, would be awkwardly implemented—perhaps not impossible, but difficult—under today's Bankruptcy Code, for reasons I will discuss.

The second occurs in the context of the ability to initiate the OLA process under Title II of the Dodd-Frank Act. Invocation of Title II itself can only occur if the Government regulators find that bankruptcy is wanting.[5] That is, by its own terms, bankruptcy is designed by the Dodd-Frank Act to be the preferred resolution mechanism.[6] The FDIC has announced that it supports the idea that bankruptcy, not OLA, should be the presumptive resolution procedure.[7] The ability of bankruptcy law to fulfill its intended role as the presumptive procedure for resolution, of course, turns on the effectiveness of bankruptcy law in rising to the challenge of accomplishing a resolution that meets three important goals: One that (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences; and (c) does not result in a Government bail-out. (In many ways, (c) is actually a direct consequence of (a): If losses are borne by appropriate, pre-identified, parties, the Government does not need to absorb losses via a bail-out.) The goal should be resolution within these constraints, not necessarily an inefficient liquidation—a goal wholly consistent with that of Chapter 11 of the Bankruptcy Code.[8]

The Current Status of the Orderly Liquidation Authority

Title II of the Dodd-Frank Act, containing the OLA, in many ways adopts many of bankruptcy law's provisions, with a key difference being that the resolution is handled by the FDIC, as receiver, retaining significant discretion, as compared to a bankruptcy court, subject to statutory rules that can and will be enforced by appellate review through the Article III judicial system.

But we are not in 2010, when the Dodd-Frank Act was envisioned and enacted. Much thinking and work has occurred since then, in terms of how, effectively, to resolve a SIFI without jeopardizing the financial system and without a Government bailout. Increasingly, attention has turned, in Europe as well as in the United States, on a rapid recapitalization. Europe has focused on a "one-entity" recapitalization via bail-in[9] while the FDIC has focused, in its SPoE proposal, on a "two-

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[4] See William F. Kroener III, Revised Chapter 14 "2.0 and Living Will Requirements Under the Dodd-Frank Act", in Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor (eds.), *Making Failure Feasible: How Bankruptcy Reform Can End "Too Big To Fail"* (Hoover Institution Press 2015).

[5] Dodd-Frank Act, §203(a)(1)(F) and (a)(2)(F); §203(b)(2) and (3).

[6] Federal Deposit Insurance Corporation, "The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy", 78 *Fed. Reg.* 76614 (Dec. 18, 2013) (hereafter "FDIC SPoE"), at 76615 ("the statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a SIFI"); see Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing, and Urban Affairs, United States Senate (December 6, 2011), available at *http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html* ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability").

[7] See Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, in Implementation of the Dodd-Frank Act before the Volcker Alliance Program (October 13, 2013), available at *http://www.fdic/gov/news/news/speeches/spoet1313.html.*

[8] There is a separate question—that I do not address (as it is not my area of expertise)—as to whether several financial institutions are simply "too big." I strongly urge that question be addressed directly—and separately. Bankruptcy law should efficiently resolve (through reorganization, recapitalization, sale, or liquidation) the entities, including financial institutions, that use it. It should not include a policy—that would be inconsistent with long-standing bankruptcy policy—favoring liquidation simply based on size.

[9] Financial Stability Board, "Progress and Next Steps Towards Ending 'Too Big To Fail'," Report of the Financial Stability Board to the G20, available at *www.financialstabilityboard.org/publications/r__130902.pdf* (Sept. 2013); Thomas Huertas, Vice Chairman, Comm. of European Banking Supervisors and Dir., Banking Sector, U.K. Fin. Services Auth., "The Road to Better Resolution: From Bail-Out to Bail-In", speech at The Euro and the Financial Crisis Conference (Sept. 6, 2010), available at *http://www.fsa.gov.uk/library/communication/speeches/2010/0906__th.shtml*; Clifford Chance, "Legal Aspects of Bank Bail-Ins" (2011).

entity" recapitalization rather than a formal bail-in.[10] Under the FDIC's approach,[11] a SIFI holding company (the "single point of entry") is effectively "recapitalized" over a matter of days, if not hours, by the transfer of virtually all its assets and liabilities, except for certain long-term unsecured liabilities, to a new bridge institution whose capital structure, because of the absence of those long-term unsecured liabilities, is both different and presumptively "sound." Because of the splitting off of the long-term unsecured debt, the bridge institution, in the FDIC's model, looks very much like a SIFI following a European-like "bail in." The major difference is that in the "bail in," the SIFI holding company before and after the recapitalization is the same legal entity (thus, the "one-entity" recapitalization), whereas in the FDIC's SPoE proposal, the "recapitalized" bridge institution, a different legal entity, is formed first and effectively receives a "new" capital structure by virtue of having long-term unsecured debt left behind in the transfer to it and the bridge institution, in turn, recapitalizes (where necessary) its operating subsidiaries (thus, the "two-entity" recapitalization)[12] In both cases, the resulting holding company then forgives intercompany liabilities or contributes assets to recapitalize its operating subsidiaries.

There are preconditions for making this work. Important among them are legal rules, known in advance, setting forth a required amount of long-term debt (or subordinate or bail-in debt) to be held by the SIFI that would be legally subordinate to other unsecured debt—in the sense of its debt-holders knowing that this debt would be "bailed-in" (in a one-entity recapitalization) or left behind (in a two-entity recapitalization).[13] Much work has been done on this dimension, both under Basel III and through the Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR).[14] And the effective use of a two-entity recapitalization in Title II of the Dodd-Frank Act needs to straddle the tension between Title II's liquidation mandate (literally met because, following the transfer to the bridge company, the assets of the original holding company will have been removed from the SIFI holding company, which will subsequently itself be liquidated) and the notion of limiting financial contagion and using Title II only when its invocation is required because of serious doubts about the effectiveness of the use of the bankruptcy process. That said, many recognize that the FDIC's SPoE proposal for Title II of the Dodd-Frank Act, consistent with parallel work in Europe, is a significant development in terms of advancing the goals of avoiding "too big to fail"—a resolution process that (a) allocates losses among the appropriate parties, (b) limits systemic consequences, and (c) avoids a Government-funded bail-out.[15]

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[10] FDIC SPoE, supra note 6. See Federal Deposit Insurance Corporation and Bank of England, Joint Paper, "Resolving Globally Active, Systemically Important, Financial Institutions" (Dec. 10, 2012), available at *http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf* (jointly proposing the single-point-of-entry approach).

[11] Early signs of which were foreshadowed in Randall Guynn, "Are Bailouts Inevitable?" 29 *Yale J. On Regulation* 121 (2012).

[12] In part, this difference is driven by different organizational structures common to U.S. SIFI's versus European SIFIs—our SIFIs are much more likely to use a holding company structure; in part this difference is driven by Title II's liquidation "mandate." Section 214(a) of the Dodd-Frank Act explicitly states: "All financial companies put into receivership under this subchapter shall be liquidated." As a bankruptcy scholar, I view this latter mandate, at least in the abstract, as unfortunate. A first-day lesson in a corporate reorganization course is that "understanding that financial and economic distress are conceptually distinct from each other is fundamental to understanding Chapter 11 of the Bankruptcy Code," Barry Adler, Douglas Baird, and Thomas Jackson, "Bankruptcy: Cases, Problems, and Materials" 28 (Foundation Press 4th ed. 2007). Avoiding a bailout requires that losses be borne by appropriate parties, identified in advance, not necessarily by liquidation of the underlying business, which may cause an unnecessary destruction of value. The FDIC's SPoE strategy formally complies with the statutory requirement, by liquidating the SIFI holding company after its assets have been liquidated via the transfer to the bridge company.

[13] See John Bovenzi, Randall Guynn, and Thomas Jackson, "Too Big To Fail: The Path to a Solution" (Bipartisan Policy Center, Failure Resolution Task Force May 2013).

[14] *www.federalreserve.gov/bankinforog/ccar.htm*

[15] See Daniel Tarullo, "Toward Building a More Effective Resolution Regime: Progress and Challenges" (Oct. 2013), available at *http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.html* ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm . . . "); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, "Planning for the Orderly Resolution of a Globally Systemically Important Bank, p.1 (Wash. DC, Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."); John Bovenzi, Randall Guynn, and Thomas Jackson, supra note 13; David Skeel, "Single Point of Entry and the Bankruptcy Alternative", in Martin Neil Baily and John B. Taylor (eds.), "Across the Great Divide: New Perspectives on the Financial Crisis" (Hoover Press 2014).

Title II's OLA provisions, however, also come with certain defects. The FDIC retains discretion to prefer some creditors over others of equal rank, without limiting it to occasions where there is background legal authority (which will rarely occur at the holding company level), and at important points the FDIC, rather than the market, is making critical determinations regarding the bridge financial company and its equity.[16] Thus, the FDIC proposes that the bridge financial institution created in the SPoE process (treated as a Government entity for tax purposes[17]) is effectively run, for a while at least, by the FDIC.[18] In addition, the FDIC's SPoE proposal relies on expert (and FDIC) valuations of the new securities that will form the basis of the distribution to the long-term creditors and old equity interests "left behind,"[19] and the FDIC retains the authority to distribute them other than according to the absolute priority rule so well known in bankruptcy law.[20]

In addition, the FDIC's SPoE proposal is, itself, potentially limited in scope:

> The FDIC's SPoE bridge proposal seemingly applies only to domestic financial companies posing systemic risk (currently, eight bank and three or four nonbank holding companies are so regarded, although more may be added, even at the last minute), not to the next hundred or so bank holding companies with more than $10 billion in consolidated assets, or to all the (potentially over one thousand) "financial companies" covered by Dodd-Frank's Title I definition (at least 85 percent of assets or revenues from financial activities).[21]

The Inadequacies of Current Bankruptcy Law Seen in Light of SPoE

I believe the "bones" for a comparably successful resolution of a SIFI under the Bankruptcy Code are already in place. But, without statutory revisions, such as I will be addressing in this Statement, those "bones" are unlikely to translate to a competitive resolution procedure to SPoE, as developed by the FDIC, under Title II of the Dodd-Frank Act.

While it is probably the case that the original "intent" of Section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—at the time of its enactment in 1978 was to permit piecemeal sales of unwanted property, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans of reorganization and (b) procedures whose essential device was a going-concern sale of some or all of the business (whether prior to or in connection with a plan of reorganization), leaving the original equity and much of the debt behind and with the proceeds of the sale forming the basis of the distribution to them according to the plan of reorganization and bankruptcy's priority rules.[22] While these going-concern sales don't fit perfectly with the original vision, which assumed the Chapter 11 company would be reorganized, not sold, such sales have been used, repeatedly, as a way of continuing a business outside of bankruptcy while the claimants and equity interests, left behind, wind up as the owners of whatever was received by the bankruptcy estate in connection with the sale. And it, at least in rough contours, has structural features in common with the two-step recapitalization that is envisioned under the FDIC's SPoE procedure.

That said, a Section 363 sale is an imperfect competitor to SPoE in its current form. While both will require identification of long-term debt (or capital structure debt) that will be left behind—again, work that is well underway[23]—a successful two-entity recapitalization essentially requires the bridge company to be able to acquire all of the remaining assets, contracts, permits, rights, and liabilities of the SIFI holding company, while preserving the businesses of the transferred, nonbankrupt, operating subsidiaries.

That seems to me very difficult to accomplish under the current Bankruptcy Code. First, because of a series of amendments designed to insulate qualified financial contracts—swaps, derivatives, and repos—from many of bankruptcy's provisions,

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[16] See FDIC SPoE, supra note 6, 76616–18.

[17] Dodd-Frank Act, section 210(h)(1) ("a bridge financial company . . . shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority").

[18] FDIC SPoE, supra note 6, 76617.

[19] FDIC SPoE, supra note 6, 76618.

[20] FDIC SPoE, supra note 6, 76619.

[21] Kenneth Scott, "The Context for Bankruptcy Resolutions", in Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor (eds.), supra note 4, at 5–6.

[22] David Skeel, "Debt's Dominion: A History of Bankruptcy Law in America" 227 (Princeton 2001); Barry Adler, Douglas Baird, and Thomas Jackson, supra note 12, at 466–467 ("between [1983 and 2003] a sea change occurred through which an auction of the debtor's assets has become a commonplace alternative to a traditional corporate reorganization").

[23] See text accompanying notes 8–15, supra.

most notably the automatic stay and the unenforceability of ipso facto clauses, there is no effective mechanism in the current Bankruptcy Code to preclude counterparties on qualified financial contracts from running upon the commencement of a bankruptcy case.[24] Importantly, even if most such contracts reside in nonbankrupt operating subsidiaries of the bridge company, such creditors may have cross-default or change-of-control provisions triggered by the Chapter 11 filing of their former holding company. (As a result of a dialogue with regulators sensitive to this problem in resolution proposals outside of bankruptcy, a major step in "solving" this concern—at least for adhering parties (initially, the 18 largest dealer banks)—occurred with the International Swaps and Derivatives Association's (ISDA's) 2014 Resolution Stay Protocol.[25]) Nor would it be clear under existing bankruptcy law that operating licenses, permits, and the like could be transferred to the bridge company, either because it legally is a new company or because there has been a change of control of the holding company and its operating subsidiaries in derogation of change-of-control provisions or requirements applicable to individual entities.[26]

Moreover, while the Bankruptcy Code clearly contemplates an ability to move with necessary speed, including when a provision calls for a notice and hearing before any decision (such as under Section 363(b)),[27] the lack of clear statutory authority for a very rapid transfer to a bridge company may leave too much—for the comfort of a SIFI or a regulatory body—up to the discretion of a particular judge who first gets a SIFI holding company requesting such a transfer. Nor is there a clear necessity for notice to, or hearing by, a Government regulator—whether the FDIC or Federal Reserve Board, in the case of the holding company, or a foreign regulator, in the case of a foreign subsidiary that is proposed to be transferred to a bridge company. These uncertainties, even with a robust resolution plan, may inspire enough lack of confidence by the FDIC and the Federal Reserve Board so as to view the commencement of an OLA proceeding under Title II of the Dodd-Frank Act to be the preferable course—or, alternatively, lack of sufficient confidence by foreign regulators so as to acquiesce in allowing the bankruptcy process to unfold without the regulator intervening at the foreign subsidiary level.

The Problems These Inadequacies Create for the Dodd-Frank Act

As noted above, resolution plans under Title I of the Dodd-Frank Act focus on bankruptcy, and Title II of the Dodd-Frank Act is, explicitly, designed to be a fallback solution to be invoked when bankruptcy is determined to be inadequate to avoid serious financial consequences on the U.S. financial system. But if the "best" resolution process we currently envision—one that, as noted above, (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences, and (c) does not result in a Government bail-out—involves, indeed, a recapitalization such as proposed by the FDIC with its SPoE procedure under Title II,[28] then there is a disconnect between design and implementation. As a result, the resolution plans will fail to do what they are supposed to do—prepare a SIFI for the most successful possible resolution—leading to OLA under Title II assuming primacy in terms of the resolution process. Moreover, the resolution plans, relentlessly focused on a bankruptcy process under Title I's own standards, will be addressing a different set of issues and will provide little guidance to the FDIC in its OLA proceeding. To have the statutory pieces "fit" together—to have resolution

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[24] Bankruptcy Code §§362(b)(6), (7), (17), (27), 546(e), (f), (g), (j), 555, 556, 559, 560, 561. (The FDIC SPoE proposal, consistent with statutory authorization, Dodd-Frank Act §210(c)(8), (9), (10), (16), will override any such provisions in counterparty contracts (and subsidiary cross-default provisions); bankruptcy, being a judicial proceeding, cannot (and should not) do that without comparable statutory authorization which currently not only is missing but is expressly contradicted by provisions that exist.) While my statement today focuses on changes that are necessary in these existing protective provisions for counterparties on qualified financial contracts in the Bankruptcy Code in order to permit an effective two-step recapitalization of a SIFI holding company, I believe these existing Bankruptcy Code provisions, and their relationship to bankruptcy law more generally, needs to be rethought. See David Skeel and Thomas Jackson, "Transaction Consistency and the New Finance in Bankruptcy", 112 *Colum. L. Rev.* 152 (2012).

[25] See ISDA, "Resolution Stay Protocol—Background", October 11, 2014; see also Tom Braithwaite and Tracy Allway, "Banks Rewrite Derivative Rules To Cope With Future Crisis", *Financial Times*, October 7, 2014.

[26] Many of these will not be executory contracts, subject to the assumption and assignment provisions of §365 of the Bankruptcy Code. Nor does the current Bankruptcy Code directly deal, apart from those provisions, with change-of-control triggers in licenses and the like.

[27] Bankruptcy Code §102(1) provides that "after notice and a hearing" includes (B) "authoriz[ing] an act without an actual hearing if such notice is given properly and if . . . (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . ."

[28] See sources cited, supra note 15.

plans effectively prepare a firm for resolution, to have bankruptcy serve as its intended role as the primary resolution device, and (beneficially) to have the resolution plans be relevant to a proceeding under Title II of the Dodd-Frank Act "just in case"—it makes sense to move, through limited but important changes to the Bankruptcy Code, from the "bones" of a successful two-step recapitalization process in the current Bankruptcy Code to a process that can deliver what it can only incompletely promise today.

Proposed Amendments to the Bankruptcy Code

Bankruptcy can be an effective resolution mechanism, tracking major features of the FDIC's SPoE proposal (but run through a bankruptcy process, with bankruptcy rules and market-based controls) that will usually, if not virtually always, obviate the need to invoke OLA under Title II of Dodd-Frank.[29] But to do so, it needs some focused amendments.

What are these changes? While any resulting bill will necessarily be complicated,[30] at the center of effectuating a bankruptcy-based two-entity recapitalization of a SIFI holding company, are two principles. First, that there is sufficient long-term unsecured debt (or "capital structure debt") at the holding company level to be "left behind" in the transfer to a bridge company so as to effectuate the recapitalization. (This is—or should be—largely an issue outside of bankruptcy law itself—and, indeed, as noted earlier, is central to a basically rule-based application of the FDIC's SPoE proposal under Title II of the Dodd-Frank Act. The precise level of those mandated capital requirements are being worked on, and already are significantly above those of 2008.) Second, that the bridge company otherwise be able to acquire all the assets, rights, and liabilities of the former holding company, including ownership of the former holding company's operating subsidiaries.[31]

Thus, the "guts" of the proposed amendments I believe are necessary to place bankruptcy law where the Dodd-Frank Act—in both Title I and Title II—envisions it should be, center on a provision that substantially sharpens the nature and focus of a sale of assets under Section 363 of the Bankruptcy Code. This provision contemplates a rapid transfer to and, in effect, recapitalization of, a bridge company (e.g., within the first 48 hours of a bankruptcy case) by a SIFI holding company (the debtor), after which the bridge company can recapitalize, where necessary, its operating subsidiaries. If the court approves the transfer, then the SIFI holding company's operations (and ownership of subsidiaries) shift to a new bridge company that is not in bankruptcy—and will be perceived as solvent by market-participants, including liquidity providers because it will be (effectively) recapitalized, as compared to the original SIFI, by leaving behind in the bankruptcy proceeding previously identified long-term unsecured (capital structure) debt of the original SIFI. After the transfer, the debtor (i.e., the SIFI holding company) remains in bankruptcy but is effectively a shell, whose assets usually will consist only of its bene-

[29] Again, the Dodd-Frank Act is explicit that Title II cannot be invoked without a determination that bankruptcy resolution would be inadequate. See notes 5 and 6, supra.

[30] In addition to the proposal contained in the Appendix, both the Senate and the House had introduced in the last session focused bankruptcy bills that largely incorporated the features I discuss next. See S. 1861, 113th Congress, 1st Sess. ("The Taxpayer Protection and Responsible Resolution Act") (December 2013); H. 5421, 113th Congress, 1st Session ("The Financial Institution Bankruptcy Act") (approved by the House via a voice vote on December 1, 2014).

[31] There is a third, important, question of access to liquidity by the bridge company that, formally is not a part of the bankruptcy process. While a potentially contentious issue, I believe there is a great deal of wisdom in David Skeel's analysis of this in *Financing Systemically Important Financial Institutions*, Chapter 3 of Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor, supra note 4. In summary: I argue in this chapter that the widespread pessimism about a SIFI's ability to borrow sufficient funds—sufficiently quickly—to finance resolution in Chapter 11 is substantially overstated. The criticism appears to be based on the assumption that the largest banks have essentially the same structure as they had prior to the 2008 panic, thus ignoring the effects of the regulatory changes that have taken place as a result of the Dodd-Frank Act. Critics also do not seem to have fully considered the likelihood that the quick sale resolution of a SIFI—like prepackaged bankruptcies of other firms should require less new liquidity than the traditional bankruptcy process. (pp. 63–64) Recognizing, however, that there is still some residual concern, Professor Skeel "conclude[s] that lawmakers should give SIFI's limited, explicit access to Fed funding, preferably by expanding the Fed's emergency lending authority under section 13(3) of the Federal Reserve Act," p. 65—where "the Fed [is] constrained under 13(3) by the requirement that it lend on a fully secured basis" as well as by the requirement that "the Fed must also determine that the loan is needed to prevent systemic or other harm." (p. 85). In general, I think the Bankruptcy Code amendments outlined here should be made irrespective of the availability of Government-based liquidity. That discussion can be held separately, and should include whether an inability of the bridge company to access Government-based liquidity under some circumstances will make more likely use of OLA under Title II of the Dodd-Frank Act, where access to the orderly liquidation fund (OLF) is clear.

ficial interest in a trust that would hold the equity interests in the bridge company until they are sold or distributed pursuant to a Chapter 11 plan, and whose claimants consist of the holders of the long-term debt that is not transferred to the bridge company and the old equity interests of the SIFI holding company. This debtor in Chapter 11 has no real business to conduct, and essentially waits for an event (such as the sale or public distribution of equity securities of the bridge company by the trust) that will value or generate proceeds from its assets (all equity interests in the new, recapitalized entity) and permit a distribution of those equity interests or proceeds, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term debt and original equity interests of the debtor (the original SIFI holding company).

The details of accomplishing this are somewhat intricate and, of course, can vary, but it is useful, I believe, to trace the general ideas of how I envision this two-step recapitalization might be implemented in bankruptcy. The transfer motion would be heard by the court no sooner than 24-hours after the filing (so as to permit 24-hour notification—I would propose—to the 20 largest holders of unsecured claims, the Federal Reserve Board, the FDIC, and the Secretary of the Treasury, and the primary financial regulatory authority—whether U.S. or foreign—with respect to any subsidiary whose ownership is proposed to be transferred to the bridge company). And, because the provisions must stay qualified financial contract termination (and related) rights (including those based on cross-defaults in nonbankruptcy subsidiaries) for a period to allow the transfer to the bridge company to be effective in a seamless fashion, the transfer decision essentially must be made within a designated period (e.g., 48 hours) after the filing. There should be conditions on the ability of the court to authorize the transfer to the bridge company—but conditions that can be satisfied by advanced planning (e.g., resolution plans) or otherwise determined within a very short timeframe.

Many of the remaining provisions that I believe would need to be adopted as well would be designed to permit the successful transfer of assets, contracts, liabilities, rights, licenses, and permits—of both the holding company and of the subsidiaries—to the bridge company.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts. Conceptually, the goal of these provisions would be to keep operating assets and liabilities "in place" so that they can be transferred to the bridge company (within a 48-hour window) and, thereafter, remain "in place" so that "business as usual" can be picked up the bridge company and its operating subsidiaries once it assumes the assets and liabilities. This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a bankruptcy case or similar circumstance, including credit-rating agency ratings, whether in the holding company or in its operating subsidiaries), [32] and it requires overriding similar provisions allowing for termination or modification based on a change of control, again whether in the holding company or in its operating subsidiaries, since the ownership of the bridge company will be different than the ownership of the debtor prior to the bankruptcy filing. These provisions need to be broader than Section 365 of the Bankruptcy Code, for at least two reasons. First, perhaps because of the limited scope of the original "purpose" of Section 363, bankruptcy doesn't have a provision expressly allowing for the "transfer" of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected") upon the filing of a petition in bankruptcy. [33] But, if there is going to be a two-step recapitalization, the bridge company needs to take the liabilities it would assume "as if nothing happened." Thus, provisions designed to accomplish that need to be included. Second, Section

[32] While these provisions would affect the contracts, permits, liabilities, and the like of entities (e.g., affiliates such as operating subsidiaries) not themselves in bankruptcy, I believe they are fully authorized (at least for domestic subsidiaries), if not by Congress' Article I bankruptcy power, then by application of the independent (albeit related) Congressional power pursuant to the "necessary and proper" clause of Article I, as interpreted since McCulloch v. Maryland, 4 Wheat. 316 (1819), see also United States v. Comstock, 560 U.S. (2010), since the bankruptcy of the SIFI cannot successfully be concluded without these provisions that permit the unimpeded transfer of the operating subsidiary's ownership to the bridge company. (The question of foreign subsidiaries, while complex, is being actively discussion by U.S. and foreign regulators, and legislation is being discussed in Europe and elsewhere that is designed to help assure these results extend to non-U.S. operations in the case involving the resolution of a U.S.-based SIFI holding company.)

[33] See David Skeel and Thomas Jackson, supra note 24.

365 doesn't deal with change-of-control provisions; amendments need to add that and extend it to debt agreements as well.

With respect to qualified financial contracts, there should be provisions in addition to those just mentioned. The stay on termination, offset, and net out rights should apply for the period from the filing until the transfer occurs, it is clear it won't occur, or 48 hours have passed. Because of this interregnum, when there is a likelihood that the transfer will be approved, and all of these qualified financial contracts (and related guarantees, if any) go over "in their original form" to the bridge company, there is a requirement that the debtor and its subsidiaries shall continue to perform payment and delivery obligations. Conversely, because the counterparty may not know for sure what the outcome will be during this interregnum, there is a provision that the counterparty may promptly "cure" any unperformed payment or delivery obligations after the transfer.

Just as the principle of having the bridge company have the same rights, assets, and liabilities drive the provisions regarding debts, executory contracts, and unexpired leases just discussed (including qualified financial contracts), a similar provision is necessary to keep licenses, permits, and registrations in place, and does not allow a Government to terminate or modify them based on an "ipso facto" clause or a transfer to a bridge company.

There are many other considerations. For example, in addition to voluntary bankruptcy proceedings initiated by the SIFI holding company, should Government regulators (such as the FDIC or FRB) have the power, under specified conditions, to initiate a bankruptcy case, and should it doing so be contestable? I believe Government regulators should be able to commence such proceedings, and (because of the very narrow time window between the filing and the transfer to a bridge company) such commencements should not be contestable in advance.[34] But I can imagine a system in which the Government regulators could not place a SIFI holding company in bankruptcy, as they retain enormous powers, either to "induce" a so-called voluntary filing (as was the case in Lehman Brothers(, or to go directly to the initiation of an OLA proceeding under Title II of Dodd-Frank. While the issue needs to be decided, in my view, which way it is resolved is not integral to the integrity of the Bankruptcy Code or the proposed amendments I have discussed. Similarly, whether the proceedings should be in front of district judges, or bankruptcy judges, and whether the judges are from a pre-designated panel, are details that may be important in ensuring the effectiveness of a 24 hour transfer, but are not at the heart of the needed amendments.

Conclusion

While the details are many, the concept is simple. Through modest amendments to the Bankruptcy Code, expressly enabling it to effectuate a rapid two-step recapitalization from a SIFI holding company to a bridge company (by leaving long-term unsecured debt behind), it indeed can be considered the primary resolution vehicle for SIFIs, as envisioned by the Dodd-Frank Act, limiting the role of Title II—and therefore administrative-based resolution—to the cases, that almost inevitably may occur, where we cannot contemplate today the causes or contours of the next crisis, so that the FDIC's inevitable discretion, compared to a judicial proceeding, becomes a virtue rather than a concern.

Absent that (hopefully rare) need, however, I view the virtues of bankruptcy resolution over agency resolution to be several. First, the new company formed in the Section 363-like recapitalization sale (or transfer) is neither (a) subject to the jurisdiction of a bankruptcy court nor (b) subject to "control" by a Government agency, such as the FDIC, whereas the bridge company created in the SPoE process is effectively run, for a while at least, by the FDIC.[35] In this bankruptcy process, the bridge company, appropriately, faces market-discipline first and foremost; in Title II, there inevitably is a heavier layer of regulatory overlay and control. Second, and related, a bankruptcy process envisions at least the possibility that the market can determine the equity value of the new company (and thus the amount to be distributed to the creditors and old equity interests "left behind"), whereas the FDIC's

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[34] Although ex post damage remedies should then be available for what was judicially determined to be an improper filing. See Kenneth Scott, supra note 24, at 9–10.

[35] See, e.g., FDIC SPoE, supra note 6, p. 76617 ("The FDIC would retain control over certain high-level key matters of the bridge financial company's governance, including approval rights for . . . capital transactions in excess of established thresholds; asset transfers or sales in excess of established thresholds; merger, consolidation or reorganization of the bridge financial company; any changes in directors of the bridge financial company (with the FDIC retaining the right to remove, at its discretion, any or all directors); any distribution of dividends; any equity based compensation plans . . . . Additional controls may be imposed by the FDIC as appropriate.").

SPoE proposal relies on expert valuations for those distributions.[36] Third, because of language in the Dodd-Frank Act,[37] the FDIC may push on its own initiative for the replacement of management (i.e., not permit management of the former SIFI holding company take similar positions in the bridge company).[38] In the bankruptcy process, the Board of Directors, and management, of the newly created bridge-company, ideally, would be identified with the input both of the SIFI's primary regulators as well as the beneficiaries of the transfer and, importantly, would be subject to the approval of the district court in an open and transparent process at the time of the transfer of the holding company's assets and liabilities to the bridge company. Fourth, at various points, the FDIC has discretion that can amount to ex post priority determinations (such as whether liabilities other than predefined long-term unsecured debt gets transferred to the bridge company)—discretion that may be useful in extraordinary cases, but that is potentially a cause for undermining market confidence in the rule of law in other circumstances.[39] Fifth, Title II treats the bridge company created in an OLA under Title II as a Government entity, exempt from taxes;[40] I think that provision is a mistake, preferring the bridge company to its nonprotected competitors, and should not be replicated in any bankruptcy amendments, whose goal is to have the bridge company treated "just as" the holding company was before the two-entity recapitalization. Sixth, and (perhaps) finally, I am concerned—as I suspect the FDIC is as well—that the actual use of SPoE under Title II of the Dodd-Frank Act will be subject to ex post criticism and investigation. Bankruptcy, with appropriate amendments—and its underlying judicial process subject to the rule of law, is in a more robust position to "do the right thing" in terms of fairly addressing the consequences of financial failure without having it necessarily lead to economic failure.

I want to thank the Subcommittee for allowing me this opportunity to present my views. It is an honor to appear before you today. I would of course be delighted to answer any questions you may have about my testimony.

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[36] FDIC SPoE, supra note 6, p. 76618 ("the SPoE strategy provides for the payment of creditors' claims in the receivership through the issuance of securities in a securities-for-claims exchange. This exchange involves the issuance and distribution of new debt, equity and, possibly, contingent securities . . . to the receiver. The receiver would then exchange the new debt and equity for the creditors' claims . . . . Prior to the exchange of securities for claims, the FDIC would approve the value of the bridge financial company. The valuation would be performed by independent experts . . . selected by the board of directors of the bridge financial company. Selection of the bridge financial company's independent experts would require the approval of the FDIC, and the FDIC would engage its own experts to review the work of these firms and to provide a fairness opinion.").

[37] Dodd-Frank Act §206(4) (the FDIC shall "ensure that management responsible for the failed condition of the covered financial company is removed"); see also Dodd-Frank Act §206(5) (similar provision for members of a board of directors).

[38] See FDIC SPoE, supra note 6, p. 76617 ("As required by the statute, the FDIC would identify and remove management of the covered financial company who were responsible for its failed condition").

[39] See, e.g., FDIC SPoE, supra note 6, p. 76618 (in addition to identified categories, the FDIC retains "a limited ability to treat similarly situated creditors differently").

[40] Dodd-Frank Act §210(h)(10) ("Notwithstanding any other provision of Federal or State law, a bridge financial company, its franchise, property, and income shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority").

CHAPTER 2

Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions

Thomas H. Jackson

Introduction

In 2012, building off of work first published in 2010, the Resolution Project proposed that a new Chapter 14 be added to the Bankruptcy Code, designed exclusively to deal with the reorganization or liquidation of the nation's larger financial institutions.[1] This proposal was, in turn, the Resolution Project's studied perspective on the most appropriate way to respond to the financial crisis of 2008 and the federal government's role in it, highlighted by the bankruptcy of Lehman Brothers. There quickly emerged a consensus—certainly among our working group, but more widespread—that the institutions, and the government, lacked important tools to deal effectively with financially distressed large financial institutions without the Hobson's choice of either potential systemic consequences affecting the nation's economy as a whole or a bailout—a financial "rescue" of the institution so that it would not fail. Chief among the perspectives that new tools were necessary was the widespread perception that bankruptcy, as it existed at that time, was simply not up to the task of resolving, according to

1. Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012); Kenneth E. Scott, George P. Shultz, and John B. Taylor, *Ending Government Bailouts as We Know Them* (Stanford, CA: Hoover Institution Press, 2010), particularly chapter 11, pp. 217–51.

the rule of law, such institutions in a fashion that would contain systemic effects.

This conclusion was the result of a number of subsidiary beliefs—some correct, some not. The bankruptcy process was too slow and cumbersome. The adversarial bankruptcy process was conducted before a judicial officer who might know the law, but didn't have the requisite economic or financial expertise or the power to consider systemic consequences. Bankruptcy had too many exclusions to deal effectively with a complex financial group (depository banks and insurance companies were wholly excluded; stockbrokers and commodity brokers were assigned to a specialized provision of Chapter 7).[2] And a series of amendments to the Bankruptcy Code, originally driven by the International Swaps and Derivatives Association (ISDA) and the Federal Reserve Board, had increasingly immunized counterparties on qualified financial contracts from the major consequences of bankruptcy, prominently including bankruptcy's automatic stay under section 362.[3]

While members of the Resolution Project believed that a number of those criticisms were justified, we also believed that thoughtful revisions to the Bankruptcy Code could ameliorate or eliminate many of them, improving the prospect that our largest financial institutions—particularly with pre-bankruptcy planning—could be reorganized or liquidated pursuant to the rule of law (especially respecting priorities to ensure that losses fell where they were anticipated). Out of that grew our proposal for a special chapter designed for such financial institutions: a Bankruptcy Code Chapter 14.[4] Key features in that proposal included: (a) allowing an entire covered financial institution, including its non-bank subsidiaries, to be resolved in bankruptcy without the existing Bankruptcy Code's potpourri of

2. These criticisms are outlined more fully in Scott et al., *Ending Government Bailouts*, 218.

3. Criticized both in Scott and Taylor, *Bankruptcy Not Bailout*, 45–46; and in David Skeel and Thomas Jackson, "Transaction Consistency and the New Finance in Bankruptcy," *Columbia Law Review* 112 (2012): 152.

4. See Scott and Taylor, *Bankruptcy Not Bailout*.

exemptions; (b) the ability of the institution's primary regulator, who may be aware of potential systemic consequences otherwise not before a bankruptcy court, to file an involuntary petition, including one based on "balance sheet" insolvency, as well as to have standing to be heard as a party or to raise motions relevant to its regulation, including filing a plan of reorganization notwithstanding a debtor's exclusive period and motions for the use, sale, and lease of property; (c) numerous changes to the protections afforded by existing bankruptcy law to holders of qualified financial contracts, especially derivatives and swaps, to ensure that they were treated according to their basic underlying attributes (that of secured liabilities, in the case of repos; that of executory contracts, in the case of derivatives and swaps); (d) provisions allowing, with designated protections against favoritism or bailout, funding for the pre-payment of certain distributions to identified creditors; and (e) the assignment of Chapter 14 cases and proceedings to designated Article III district judges, rather than to bankruptcy judges without the political independence provided by Article III.[5]

In proposing this, we wrote:

> We, the members of the Resolution Project group, believe it is possible through these changes to take advantage of a judicial proceeding—including explicit rules, designated in advance and honed through published judicial precedent, with appeals challenging the application of those rules, public proceedings, and transparency—in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new chapter could be adopted either in addition or as an alternative to the new resolution regime of Dodd-Frank.
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> The crucial feature of this new Chapter 14 is to ensure that the covered financial institutions, creditors dealing with them, and other market participants know in advance, in a clear and predictable way, how losses will be allocated if the institution fails. If the creditors of a

5. For more detail, see ibid., 26–70.

> failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk taking by the financial institution's management is destroyed, and their losses are transferred to others.[6]

Even with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[7] with its own Title II resolution process run by the Federal Deposit Insurance Corporation—the Orderly Liquidation Authority—we believe these changes to bankruptcy law remain vital to accomplish several of the announced goals of Dodd-Frank itself. First, Title I's resolution plans—which we believe are an important part of pre-bankruptcy planning—require a focus on using bankruptcy as the standard against which their effectiveness will be measured.[8] And, second, invocation of Title II itself can only occur if the government regulators find that bankruptcy is wanting.[9] Unless bankruptcy can be seen as a viable alternative for the resolution of a large and complex systemically important financial institution (SIFI) in economic distress, (a) the resolution plans could technically be found not credible or facilitating an orderly liquidation (since they are to be based on bankruptcy) and (b) breakup, or use of Title II of Dodd-Frank, will be the only perceived effective responses to the "too big to fail" problem.[10]

Those remain important reasons for the adoption of many of the proposals the Resolution Project put forth in its original 2012 Chapter 14 proposal. That proposal, however, consistent with most of

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6. Ibid., 26.

7. Pub. L. No. 111-203, 124 Stat. 1376 (Dodd-Frank Act).

8. Dodd-Frank Act, section 165(d). The ways in which a proposal such as the one contained in this chapter would bring congruity to those provisions is explored in William Kroener, "Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act," chapter 8 in this volume.

9. Ibid., sections 203(a)(1)(F) and (a)(2)(F); sections 203(b)(2) and (3).

10. Reducing the size, and not just the complexity, of large financial institutions may be independently desirable, but that goal—if indeed it is one—should not be conflated with designing an appropriate mechanism for the effective resolution of a financial institution in distress.

the thinking and work being done at that time, was focused on the resolution of an operating institution—which, in the case of a large financial institution, is usually at the subsidiary level of a holding company. Yet, in addition to the concerns with existing bankruptcy law, Title II, as enacted, had its own set of difficulties with effective resolution of any such financial institutions. Title II is designated the "Orderly *Liquidation* Authority,"[11] and section 214(a) explicitly states: "All financial companies put into receivership under this subchapter shall be liquidated."[12] A first-day lesson in a corporate reorganization course is that "understanding that financial and economic distress are conceptually distinct from each other is fundamental to understanding Chapter 11 of the Bankruptcy Code."[13] Thus, what of a company whose going-concern value exceeds its liquidation value? But if bankruptcy is perceived not to be up to the task and Title II required an actual liquidation of the business, there may be many cases in which the condition precedent for the use of Title II—that it will be more effective than bankruptcy—will not be met, and current bankruptcy will (or, under the terms of Dodd-Frank, should) be the (rather inefficient) result.

Since then, however, a sea change in perspective has occurred.[14] Increasingly, the focus, in Europe as well as in the United States, has been on a reorganization or recapitalization that focuses, in the first instance, on the parent holding company (many or most of the assets of which are the equity ownership of its subsidiaries). Europe has focused on a

11. Dodd-Frank Act sections 206 and 208 (emphasis added).

12. Ibid., section 214(a). See also Thomas Jackson and David Skeel, "Dynamic Resolution of Large Financial Institutions," *Harvard Business Law Review* 2 (2012): 435, 440–41.

13. Barry Adler, Douglas Baird, and Thomas Jackson, *Bankruptcy: Cases, Problems, and Materials,* 4th ed. (St. Paul, MN: Foundation Press, 2007), 28.

14. A useful discussion of whether and how well Title II of Dodd-Frank would have responded to the 2008 crisis—prior to the development of the SPOE proposal—is contained in David Skeel, "Single Point of Entry and the Bankruptcy Alternative," in *Across the Great Divide: New Perspectives on the Financial Crisis* (Stanford, CA: Hoover Institution Press, 2014). Cf. Emily Kapur, "The Next Lehman Bankruptcy," chapter 7 in this volume.

"one-entity" recapitalization via bail-in[15] while the FDIC has focused in its single-point-of-entry (SPOE) proposal on a "two-entity" recapitalization.[16] Under the FDIC's approach, a SIFI holding company (the "single point of entry") is supposed to effectively achieve "recapitalization" of its business virtually overnight by the transfer of its assets and liabilities, except for certain long-term unsecured liabilities and any subordinated debt, to a new bridge institution. The bridge institution then is supposed to forgive intercompany liabilities or contribute assets to recapitalize its operating subsidiaries. Because of the splitting off of the long-term unsecured debt, the bridge institution, in the FDIC's model, looks very much like a SIFI holding company following a European-like bail-in. The major difference is that in the bail-in, the SIFI holding company before and after the recapitalization is the same legal entity (thus, the one-entity recapitalization), whereas in the FDIC's SPOE proposal, the recapitalized bridge institution is legally different than the pre-SPOE SIFI holding company (thus, the two-entity recapitalization).

There are preconditions for making this work. Important among them are legal rules, known in advance, setting forth a required amount of long-term debt to be held by the holding company that would be legally subordinate to other unsecured debt—in the sense of being known that it would be bailed-in (in a one-entity recapitalization) or left behind (in a two-entity recapitalization).[17] And its

15. Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big-to-Fail,"* Report of the Financial Stability Board to the G-20, September 2, 2013, www.financialstabilityboard.org/publications/r_130902.pdf; Thomas Huertas, "The Road to Better Resolution: From Bail-out to Bail-in," speech at The Euro and the Financial Crisis Conference, September 6, 2010, http://www.fsa.gov.uk/library/communication/speeches/2010/0906_th.shtml; Christopher Bates and Simon Gleeson, "Legal Aspects of Bank Bail-Ins," Clifford Chance client briefing, May 3, 2011.

16. FDIC SPOE, Federal Deposit Insurance Corporation, The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

17. See Kenneth E. Scott, "The Context for Bankruptcy Resolutions," chapter 1 in this volume; see also John Bovenzi, Randall Guynn, and Thomas Jackson, "Too Big to Fail: The Path to a Solution," panel discussion, Bipartisan Policy Center, Failure Resolution Task Force, Washington, DC, May 2013.

effective use in Title II—as of this writing the FDIC has promulgated for comments a working document on its SPOE proposal[18]—needs to straddle the tension between Title II's liquidation mandate (literally met because, following the transfer to the bridge company, the original holding company will be liquidated) and the notion of limiting financial contagion and using Title II only when its results are better than would occur in bankruptcy. That said, many recognize that the FDIC's SPOE proposal for Title II of Dodd-Frank, consistent with parallel work in Europe, is a significant advance in terms of undermining the presumption that some firms are "too big to fail."[19]

But it also comes with the defects that have always made us uncomfortable with a resolution proceeding run and dominated by a government agency. The FDIC retains discretion to prefer some creditors over others of equal rank, without limiting it to occasions where there is background legal authority (which will rarely occur at the holding company level), and at important points the FDIC, rather than the market, is making critical determinations regarding the bridge financial company and its equity.[20] Thus, the FDIC proposes that the bridge financial institution created in the SPOE process (treated as a government entity for tax purposes[21]) is effectively run, for a while at least, by the FDIC.[22] In addition, the FDIC's SPOE proposal relies on expert (and FDIC) valuations of the new securities that will form the basis of the distribution to the long-term creditors and old equity interests "left behind,"[23] and the FDIC retains the authority to distribute them other than according to the absolute priority rule so well known in bankruptcy law.[24]

18. See FDIC SPOE.

19. See Bovenzi et al., "Too Big to Fail," and Skeel, "Single Point of Entry."

20. See FDIC SPOE, 76616–18.

21. Dodd-Frank Act, section 210(h)(10) ("a bridge financial company . . . shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, country, municipality, or local taxing authority").

22. FDIC SPOE, 76617.

23. Ibid., 76618.

24. Ibid., 76619.

Moreover, the SPOE proposal for Title II has the potential to create an even greater disconnect with both Title I of Dodd-Frank and the presumptive preference for use of bankruptcy in Title II. The first occurs because Title I's resolution plans are to be focused on what would happen to the financial institution *in bankruptcy*.[25] Without the ability to do a comparable recapitalization at the holding company level in bankruptcy, any resolution plan would not be focused on how to most effectively do such a recapitalization. And that would be particularly unfortunate because, without the kind of changes in bankruptcy law we propose, Title II—and its SPOE process—would become the default, not the extraordinary, process, which runs contrary to the express preference in Dodd-Frank for bankruptcy as a resolution process for financial institutions.[26]

Accordingly, the Resolution Project focused on what further changes might be appropriate in its Chapter 14 proposal to both (a) meet the original goals of an effective reorganization or liquidation of an operating company and (b) provide an effective mechanism that would accomplish the goals inherent in the one- or two-entity recapitalizations of the holding company suggested by bail-in and SPOE proposals. Again, the bones of a response to this are already inherent in the Bankruptcy Code. While it is probably the case that the original intent of section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—was to permit piecemeal sales of unwanted property, following the enactment of the Bankruptcy Code of 1978, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans and (b) plans whose essential device was a going-concern sale of some or all of the business, leaving the original equity and much of the debt behind—with the proceeds of the sale forming the basis of their distribution according to the absolute priority rule.[27] It doesn't fit perfectly, but it

25. Dodd-Frank Act, section 165(d); and Kroener, "Revised Chapter 14 2.0."

26. Dodd-Frank Act, sections 203(a)(1)(F) and (a)(2)(F); sections 203(b)(2) and (3).

27. David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton, NJ: Princeton University Press, 2001), 227; and Adler et al.,

has been used, repeatedly, as a way of creating a viable business outside of bankruptcy while the claimants, left behind, wind up as the owners of the estate of the former business entity.

Thus, the Resolution Project Working Group decided to expand its 2012 Chapter 14 proposal (which, for the purpose of clarity, we will designate Chapter 14 1.0) to include a direct recapitalization-based bankruptcy alternative—a Chapter 14 2.0. Chapter 14 2.0 accommodates *both* a conventional reorganization of an operating company *and* a two-entity recapitalization of a holding company (as well as, in appropriate circumstances, an operating company).[28] While there is a great deal of merit in considering ways of successfully implementing one-entity recapitalization, especially for the many financial companies that are not systemically important (and we have considered those possibilities extensively among ourselves), in the United States, at least, it is simpler for SIFIs to build upon the two-entity recapitalization model. This is both because (a) Chapter 14 may operate in parallel to the FDIC's SPOE proposal under Title II of Dodd-Frank and because Dodd-Frank itself looks to bankruptcy as the primary "competitor" to Title II[29] and (b) because it is, for a variety of reasons, easier to use the existing bankruptcy framework for a two-entity recapitalization than it is for a one-entity recapitalization.

While there are certainly overlaps with the way Chapter 14 1.0 works—and would continue to work for conventional reorganizations of operating companies—the features that facilitate a two-entity recapitalization through bankruptcy are structurally somewhat distinct. They—together with the basic features of Chapter 14 1.0—are incorporated in the Chapter 14 2.0 proposal.[30] In this paper, we will,

Bankruptcy: Cases, Problems and Materials, 466–67 ("Between [1983 and 2003] a sea change occurred through which an auction of the debtor's assets has become a commonplace alternative to a traditional corporate reorganization").

28. A section-by-section outline of this Chapter 14 2.0 proposal is contained in the Appendix, and will be referred to throughout.

29. Dodd-Frank Act, sections 203(a)(2)(F) and (b)(2).

30. A Senate bill, S. 1861, 113th Congress, 1st Sess. ("The Taxpayer Protection and Responsible Resolution Act") (December 2013) focuses on amending the Bankruptcy Code so as to incorporate provisions for a two-entity recapitalization,

first, outline the basic features of Chapter 14 1.0 vis-à-vis the reorganization or liquidation of an operating company and point to where they (sometimes with modifications) are located in Chapter 14 2.0. We will then focus on the additional provisions that form the basis for the two-entity recapitalization of a holding company that is at the center of the differences between the two versions.

But, first, a brief description of the differences between the two processes. The reorganization or liquidation of an operating company that was the focus of Chapter 14 1.0, and the "quick sale" recapitalization that is the major driver of the changes in Chapter 14 2.0, trigger off of whether there is a motion for, and approval of, a "section 1405 transfer"[31] (as defined in our section-by-section proposal that forms an appendix to this chapter) within the first forty-eight hours of a bankruptcy case. If the court approves such a section 1405 transfer, then the covered financial corporation's operations (and ownership of subsidiaries) shift to a new bridge company *that is not in bankruptcy*, in exchange for all its stock.

Through the transfer, this new bridge company will be (effectively) recapitalized, as compared to the original covered financial corporation, by leaving behind in the bankruptcy proceeding certain preidentified (by regulators such as the Federal Reserve Board or by the parties themselves through subordination or bail-in provisions) long-term unsecured debt (called in the proposal "capital structure debt") of the original covered financial corporation. *After* the transfer, the covered financial corporation (the debtor) remains *in bankruptcy* but is effectively a shell, whose assets usually will consist only of beneficial

without ancillary provisions for a more traditional reorganization or liquidation as contemplated by Chapter 14 1.0. The House Judiciary Committee has introduced a similar bill, "The Financial Institution Bankruptcy Act," H. 5421 (August 2014) on a unanimous voice vote. That bill, with minor changes, was subsequently approved by the full House, also via a voice vote, on December 1, 2014—although, without action by the Senate, the process is restarted with the new session of Congress in 2015. We believe this is a positive step, though a complete bankruptcy solution should incorporate not just two-entity recapitalization provisions, but also provisions teed off of Chapter 14 1.0.

31. Appendix, section 2(6).

ownership of the equity interests in the bridge company (held on its behalf by a special trustee) and whose claimants consist of the holders of the long-term debt, any subordinated debt, and the old equity interests of the covered financial corporation. It has no real business to conduct, and essentially waits for an event (such as an IPO for public trading in equity securities of the bridge company) that will value its assets (all equity interests in the new, recapitalized entity) and permit a sale or distribution of those assets, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term and subordinated debt and original equity interests of the debtor (the original covered financial corporation).

Essentially, Chapter 14 2.0 includes four types of rules. One set, centered around the section 1405 transfer, is specific to the mechanics of the two-entity recapitalization's transfer to the bridge company—keeping the other assets, debts, executory contracts, qualified financial contracts, and the like, "in place" and "intact" so they can be transferred to the bridge company. Another set of Chapter 14 rules, as noted above, is specific to the mechanisms of the reorganization of an operating company by keeping the covered financial corporation a "going concern" during its reorganization. A third set of rules deals with the conceivable possibility that the section 1405 transfer won't be approved, and thus provides for the transition from rules appropriate to the two-entity recapitalization to those appropriate to the reorganization (or liquidation) of the covered financial corporation in bankruptcy. Finally, a fourth set of rules is common for all cases in Chapter 14, and thus applies to both a one-entity reorganization and a two-entity recapitalization. Many of these rules are those provided by Chapters 1, 3, 5, and 11 of the current Bankruptcy Code, which Chapter 14 expressly makes relevant (unless overridden by a provision of Chapter 14 itself) to all Chapter 14 cases, as augmented by the proposals suggested in our 2012 Chapter 14 1.0 proposal.

Chapter 14 1.0

The 2012 Chapter 14 1.0 proposal centered around five basic areas where new provisions were added and existing bankruptcy provisions

were modified. They were: (A) provisions applying to the creation of a new Chapter 14;[32] (B) provisions relevant to the commencement of a Chapter 14 case;[33] (C) provisions involving the role of the primary regulator in the bankruptcy proceeding;[34] (D) provisions involving debtor-in-possession financing;[35] and (E) provisions applicable to qualified financial contracts in Chapter 14.[36] The essence of these proposals is summarized next, although fuller treatment, of course, is contained in the 2012 Chapter 14 1.0 proposal itself.

Provisions Applying to the Creation of a New Chapter 14

Recognizing that the provisions for a reorganization proceeding in Chapter 11 and a liquidation proceeding in Chapter 7 provided a solid starting point—together with the general provisions in Chapters 1, 3, and 5—Chapter 14 was built around the premise that a large financial institution (and its subsidiaries) would generally use those rules *except* where Chapter 14 was designed to explicitly change them. It accordingly called for a large financial institution[37] to concurrently file for both Chapter 14 and either Chapter 7 or Chapter 11.[38] Because of concerns about political independence, as well as judicial expertise, a Chapter 14 case would be funneled to pre-designated district judges in the Second and District of Columbia circuits, who were expected to hear the cases themselves rather than referring them to bankruptcy judges.[39] The district judges were given the express right to appoint a special master from a predesignated panel to hear Chapter 14 cases and proceedings connected with a Chapter 14 case, as well as the designation of bankruptcy judges and experts to provide advice and input.[40]

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32. Scott and Taylor, *Bankruptcy Not Bailout*, 27–33.
33. Ibid., 34–38.
34. Ibid., 39–40 and 44–45.
35. Ibid., 40–44.
36. Ibid., 45–66.
37. See Scott and Taylor, *Bankruptcy Not Bailout*, 28; Appendix, section 1(1).
38. Ibid., 29–30; Appendix, section 1(2).
39. Ibid., 33; Appendix, section 3(1).
40. Ibid., 33; Appendix, section 3(1).

Provisions Relevant to the Commencement of a Chapter 14 Case

To ensure that the entire financial institution could be dealt with in the Chapter 14 case, Chapter 14 1.0 proposed to eliminate the exclusion in existing bankruptcy law for domestic and foreign insurance companies, as well as stockbrokers and commodity brokers, from Chapter 11 when a Chapter 14 case applied, although existing rules for the treatment of customer accounts would be made applicable to the bankruptcy proceedings of stockbrokers and commodity brokers. The Securities Investor Protection Corporation (for stockbrokers) or the Commodity Futures Trading Commission (for commodity brokers) would be given a right to be heard and file motions.[41] Chapter 14 1.0, however, did not change the current resolution practice of the FDIC over depository banks.[42]

Provisions Involving the Role of the Primary Regulator in the Bankruptcy Proceeding

In addition, a financial institution's primary regulator would be given the right to file an involuntary case against that financial institution and the right to do so, if contested, not just in the case of the institution generally not paying its debts as they become due, but also on the ground that either the financial institution's assets were less than its liabilities, at fair valuation, or the financial institution had an unreasonably small capital.[43]

Beyond the filing of an involuntary petition by a financial institution's primary regulator, the regulators of the business of a financial institution or any subsidiary thereof would have standing, with respect to the financial institution or the particular subsidiary, to be heard as parties and to raise motions relevant to their regulation.[44] The primary regulator would additionally be given the power, in parallel with the trustee or debtor-in-possession, to file motions for the use, sale, or lease of property of the estate pursuant to the procedures of section

41. Ibid., 35–36; Appendix, section 1(1).
42. Ibid., 36; Appendix, section 1(1).
43. Ibid., 37–38; Appendix, sections 2(3) and (4).
44. Ibid., 39; Appendix, sections 2(2) and (5).

363 of the Bankruptcy Code.[45] Either the primary regulator or a creditors' committee would be permitted to file a plan of reorganization at any time.[46]

Provisions Involving Debtor-in-Possession Financing

The Chapter 14 1.0 proposal would make it clear that debtor-in-possession (DIP) financing is available in Chapter 14, pursuant to section 364's procedures and limitations, for financing that will permit partial or complete payouts to some or all creditors where liquidity or solvency of those creditors is a systemic concern, with those payments intended as "advances" for the likely payouts such creditors would receive in a liquidation or a reorganization at the end of the bankruptcy process. To ensure that this was not a backdoor way of providing financial favoritism, these distributions would be subject to several burden-of-proof requirements, to be passed on by the district judge, as well as subordination of the claim of the entity providing such funding to the extent that the creditors receiving such distributions received more than they would have in the bankruptcy proceeding absent such funding. Moreover, if the government was the entity providing such funding, it would additionally be required to show that no private funding on reasonably comparable terms was available within the time frame required.[47]

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45. Ibid., 40; Appendix, section 2(2).

46. Ibid., 45; Appendix, section 2(5).

47. Ibid., 43–44; Appendix, section 2(14). That provision, which adds a section 1413, picks up the provisions regarding debtor-in-possession financing from Chapter 14 1.0. This provision is essentially for use in Chapter 14 1.0's reorganization of an operating entity model that is carrying on an active business and that needs liquidity in the bankruptcy proceeding, and perhaps may need, for financial stability purposes, prepayments to some claimants. It builds on the debtor-in-possession financing provisions of section 364 of the Bankruptcy Code. In the case of a section 1405 transfer (see Appendix, section 2(6)), the judge will retain jurisdiction over the bridge company, on its application, sufficient to allow the Chapter 14 court to authorize for a limited period comparable funding, subject to conditions, available to a debtor-in-possession under section 1403.

Provisions Applicable to Qualified Financial Contracts in Chapter 14

Rules written into the Bankruptcy Code over the past several decades have increasingly exempted counterparties on qualified financial contracts from many of bankruptcy law's special rules, including the automatic stay and preference law. Occasionally, these exemptions make underlying sense, but often they do not. In Chapter 14 1.0, our Working Group proposed revisiting all these Code provisions, and treating the counterparties according to the underlying attributes of the contracts they possessed. In the case of counterparties on repo (repurchase) contracts, which are comparable to secured loans, the automatic stay would not apply in terms of netting, setoff, or collateral sales by the counterparty of cash-like collateral that is in its possession—each being an instance of rights that the counterparty could exercise without detriment to the debtor or its estate.[48] In the case of counterparties on derivatives, however, more significant short-term changes in existing law were proposed, again consistent with the idea that most derivatives were comparable to executory contracts, and should be treated as such. Thus, for three days, the counterparty would be subject to bankruptcy's automatic stay, so as to enable the debtor to exercise its choice between assumption and rejection of the derivative (although the debtor would need to accept or reject all of the counterparty's derivatives without cherry-picking). After three days, and unless the debtor had previously assumed the derivative, the counterparty would be free to exercise any rights it may have to terminate the derivative and, upon termination (either by action of the counterparty or by rejection by the debtor), the counterparty will have the netting, setoff, and collateral sale rights of a repo counterparty in bankruptcy.[49]

Finally, counterparties on qualified financial contracts would be given no blanket exemption from the trustee's avoiding powers, including preference law, although preference law would be amended

48. Ibid., 50–52; Appendix, section 2(8).

49. Ibid., 56–60; Appendix, section 2(8).

to provide a "two-point net improvement test" safe harbor for certain payments and collateral transfers.[50]

Incorporating a "Quick Sale" Recapitalization into Chapter 14

While most of these provisions continue to make sense, and apply as well to the reorganization or liquidation of an operating company, they—by themselves—are not focused sufficiently on a rapid recapitalization of a financial institution at the holding company level (or, indeed, the rapid recapitalization of an operating covered financial corporation), in which—in the course of a very short period of time—it is intended that the financial institution, through the recapitalization, would (a) likely be solvent, (b) appear solvent to market participants, and (c) be subject to market discipline, rather than be under the "protection" of a bankruptcy proceeding (or subject to the interference with market-based decisions by a judge overseeing the bankruptcy proceeding of the holding company).

Doing this requires several new provisions and counsels for some modifications in the proposals contained in Chapter 14 1.0. The most significant change in the Chapter 14 2.0 proposal is its focus on provisions implementing a quick recapitalization of a covered financial corporation (usually a holding company), via a sale of its assets and liabilities (other than certain pre-identified long-term unsecured debt and subordinated debt) to a bridge company immediately following the commencement of a bankruptcy case.[51] In essence, this quickly removes the assets from the bankruptcy process, in the form of a new,

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50. Ibid., 62–66; Appendix, section 2(12).

51. Appendix, section 2(6) (describing a section 1405 "Special Transfer"). If the entity does not have regulatory-required capital structure debt, and does not have contractually subordinated debt, it will be unlikely to be able to use section 1405's "quick transfer," as there will be little, if anything, left behind in the transfer (other than equity). This will almost certainly mean the financially distressed covered financial institution will be unable to demonstrate, as section 1405 requires, that the bridge company can provide adequate assurance of future performance of the debts and contracts being transferred to it. Thus, while not limited to holding companies, the use of section 1405 will require that the covered financial

and hopefully clearly solvent, company, while leaving full beneficial ownership rights of that company (as between the holders of the long-term and subordinated debt that is not transferred and the old equity holders who are also left behind) to be realized over time in the bankruptcy estate. In addition to requiring pre-identified long-term debt in sufficient quantity—a non-bankruptcy issue but critical to the ability of *either* Chapter 14's quick sale *or* the FDIC's SPOE process to succeed[52]—it requires a series of rules permitting assets, liabilities, contracts, and permits to be transferred to the bridge company notwithstanding restrictions on transfer, or change-of-control provisions, or the like. In essence, a number of rules need to be in place to ensure that, but for the recapitalization, the bridge company has all of the rights and liabilities that the holding company had the moment before the commencement of the bankruptcy case. Virtually all of the new rules in the Chapter 14 2.0 proposal are designed to deal with this, although there are also some transitional rules, some changes in the Chapter 14 1.0 proposal based on making the "quick sale" effective, and some (modest) changes in the Chapter 14 1.0 proposal based on our current thinking.

The Section 1405 Transfer

The heart of the change is what we have denominated the section 1405 transfer.[53] This transfer is, in many ways, the key concept implementing the two-entity recapitalization idea in Chapter 14. It permits the debtor or either the Board (in cases where the Board has supervisory authority over the debtor—usually the largest financial institutions) or its primary regulator (in other cases)[54] that commences a bankruptcy case to immediately make a motion for a transfer of the property of the estate, contracts, and liabilities (except for "capital

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corporation have debt that can be left behind, thus accomplishing the financial reorganization contemplated by the section 1405 transfer.

52. See Scott, "The Context for Bankruptcy Resolutions."

53. Appendix, section 2(6).

54. Defined in Appendix, section 2(3) (and slightly modified from the Chapter 14 1.0 proposal).

structure debt"—our term for the debt that is left behind—and, of course, equity)[55] of the debtor to a newly created bridge company.[56] If the transfer is approved, every asset, liability, and executory contract of the debtor will be included in the transfer to the bridge company *except* for capital structure debt (and equity). If the debtor owns collateral that secures a loan (other than via a qualified financial contract) with an original maturity of at least one year, upon its transfer pursuant to section 1405 to the bridge company, the secured lender's claim against the bridge company will be non-recourse if its deficiency claim would otherwise be considered capital structure debt.[57] However, through that definition of capital structure debt, such a lender will, if the collateral is insufficient, continue to have an unsecured claim for any deficiency in the Chapter 14 case.[58]

The section 1405 transfer motion shall be heard by the court no sooner than twenty-four hours after the filing (so as to permit twenty-four-hour notification to the debtor, the twenty largest holders of the capital structure debt, the Board and the FDIC [in the case of a debtor over whom the Board has supervisory authority], and also the primary financial regulatory authority—whether US or foreign—with respect to the debtor as well as any subsidiary whose ownership is proposed to be transferred to the bridge company in the section 1405 transfer).[59] Based on limited stays in other provisions in Chapter 14, the transfer decision essentially must be made within forty-eight hours after the filing.[60] The court can order the transfer only if it finds, or the Board or primary regulator (as the case may be) certifies that it

55. Defined in Appendix, section 2(3). A part of this definition of capital structure debt begins the idea, finished in Appendix, section 2(6), that under-collateralized long-term secured debt will be treated as follows: (a) the secured portion of the debt will be transferred (along with the collateral) to the bridge company on a non-recourse basis and (b) the debt holder will retain an unsecured claim in the debtor's bankruptcy for the remainder.

56. Ibid., section 2(3).

57. Ibid., sections 2(3) and (6).

58. Ibid., section 2(3).

59. Ibid., section 2(6).

60. See ibid., sections 2(7) and (8).

has found, that the bridge company adequately provides assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company.[61] The court must also confirm that the bridge company's bylaws allow its board to be replaced, pursuant to a decision of the Chapter 14 judge after a notice and hearing for the equity owners of the bridge company (collectively, the debtor; individually, the holders of the capital structure debt and equity interests of the debtor), and other parties in interest (such as the Board and/or primary regulator), during the first thirty days following the section 1405 transfer to that bridge company.[62] Moreover, while the bridge company is not otherwise subject to the jurisdiction of the Chapter 14 judge following the transfer, that judge shall retain jurisdiction for one year, upon application of the bridge company, to award financing on the terms and conditions applicable to DIP financing pursuant to section 1413. This is done in order to provide access to liquidity in the (hopefully rare) occasions where market-based liquidity to the presumptively solvent bridge company is unavailable. It is limited to six months on the view that any market-based liquidity restrictions (whether local or global) will have dissipated or otherwise been dealt with by that time and the bridge company is thereafter on its own.[63]

Commencing the Chapter 14 Case

While many of the commencement provisions in the Chapter 14 1.0 proposal have been carried forward, there have also been some modest changes, based largely on the necessity for a decision on a section 1405 transfer within forty-eight hours of the filing. While Chapter 14 itself is new, there will be provisions noting that, except where otherwise expressly provided by Chapter 14, the "non-substantive" chapters of the Bankruptcy Code (Chapters 1, 3, and 5) apply in Chapter 14, and

61. Ibid., section 2(6). If the certifications are challenged, the Chapter 14 judge, after appropriate proceedings, may award damages, ibid., section 2(4), and sovereign immunity is to that extent abrogated, ibid., section 1(3).

62. Ibid.

63. The more general subject of financing such institutions is explored in David Skeel, "Financing Systemically Important Financial Institutions in Bankruptcy," chapter 3 in this volume.

that, again except where otherwise expressly provided by Chapter 14, the provisions of Chapter 11 apply in a case under Chapter 14.[64] While there is no provision for the direct use of Chapter 7, liquidations are permitted under Chapter 11 and a conversion to Chapter 7 under section 1112 of the Bankruptcy Code is expressly allowed.[65] Because Chapter 14 generally incorporates the provisions of Chapter 11, there is no need for a concurrent filing under Chapters 14 and 11, as proposed in Chapter 14 1.0, although the substance is the same. (The current Chapter 14 2.0 proposal is, in substance, similar to making the provisions of Chapter 14 a new subchapter of Chapter 11.)

Chapter 14 can only be used by a "covered financial corporation,"[66] whose definition picks up institutions that are "substantially engaged in providing financial services or financial products," including subsidiaries that are neither banks (that currently are, and would remain, subject to FDIC resolution procedures), nor a stockbroker or commodity broker (which goes into special Chapter 7 provisions).[67] (While subsidiaries of a covered financial corporation—that are themselves excluded banks, stockbrokers, or commodity brokers—cannot file in Chapter 14, a parent institution owning such subsidiaries can nevertheless use Chapter 14.) In common with Chapter 14 1.0, there is no exclusion of insurance companies.[68] The minimum size requirement of Chapter 14 1.0 has been dropped on the view that Chapter 14 provides a superior reorganization mechanism for all financial institutions. The definition of "covered financial corporation," however, specifically excludes financial market infrastructure corporations (such as central counterparty clearinghouses) as unsuited for Chapter 14, even if they otherwise meet the definition of a covered financial corporation.[69]

As for the commencement of a Chapter 14 case, Chapter 14 2.0 picks up on, but modifies, the provisions for the commencement of

64. Appendix, section 1(2).
65. Ibid., section 1(3).
66. Ibid.
67. Ibid., section 1(1).
68. Ibid.
69. Ibid. See Darrell Duffie, "Resolution of Failing Central Counterparties," chapter 4 in this volume.

a Chapter 14 case in Chapter 14 1.0. It continues with the ability of the covered financial corporation itself (the debtor) to file a voluntary petition under section 301 of the Bankruptcy Code.[70] It does not, however, permit three or more creditors of a covered financial corporation to file an involuntary petition under section 303 of the Bankruptcy Code, as this was thought to be both potentially disruptive and unnecessary, particularly when a section 1405 transfer might be the preferred solution, as the time-table for that determination simply doesn't accommodate time for a distinct hearing and resolution on the merits of the involuntary petition itself.[71] It does allow the Federal Reserve Board to file what is tantamount to a voluntary petition for covered financial corporations over which it has supervisory authority, in legal effect (e.g., the filing commences the case and constitutes an order for relief), if the Board certifies (and makes a statement of the reasons) that it has determined (after consultation with the secretary of the treasury and the FDIC) that either the commencement of a Chapter 14 case is necessary to avoid serious adverse effects on the financial stability of the United States[72] or the covered financial corporation has substantial impairment of regulatory capital. In other cases, the primary regulator may file a comparable petition in which the commencement of the case and the order for relief are simultaneous, upon a certification that the primary regulator has determined that the covered financial corporation's assets are less than its liabilities, at fair valuation, or the covered financial corporation has unreasonably small capital. This substitutes the Board, in instances where it is has supervisory authority, for Chapter 14 1.0's proposal regarding the primary regulator, makes several other changes in the standard, and makes the petition function equivalent to a voluntary petition (i.e., immediate order for relief) rather than an involuntary petition (that can be challenged before an order for relief). This was done with the thought that because of the very tight time constraint to approve a section 1405 transfer (after notice and hearing), in cases

70. Appendix, section 2(4).

71. Ibid.

72. Ibid.

where it is otherwise appropriate, there simply wasn't time to have a meaningful insolvency hearing; in addition, once the filing was made, it was likely to be a self-fulfilling prophecy. In its place is a Board certification regarding impairment of regulatory capital or financial stability or a primary regulator's certification concerning balance sheet insolvency (e.g., assets less than liabilities) or unreasonably small capital. However, the court would retain jurisdiction to subsequently hear and determine damages proximately caused by such filing, if it finds that the Board's or primary regulator's certification was not supported by substantial evidence on the record as a whole (analogous in some respects to the damages provision of section 303(i)(2)(A)), so that there is an understanding that aggrieved parties (mostly the original equity holders of the debtor) could have ex post damage remedies.[73]

In terms of who oversees the Chapter 14 case, the Chapter 14 1.0 proposal essentially displaced non–Article III bankruptcy judges with Article III district judges to handle Chapter 14 cases, and funneled all such cases to the Second and District of Columbia circuits. We propose the same basic idea of using district judges, but have made some modifications in the original proposal. First, rather than funneling cases to the Second Circuit or the DC Circuit, it has at least one designated district court judge (selected by the chief justice of the United States) in each circuit who will be involved in Chapter 14 cases.[74] Ordinary venue rules (in 28 USC section 1408) determine where the covered financial corporation files (or the Board commences a case involving a covered financial corporation). Because a designated judge, while within the judicial circuit, may not be within the judicial district where the Chapter 14 case is commenced, the provision deems the judge to be temporally assigned to the district in which the bankruptcy case is commenced.[75] (This decision to involve a judge

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73. Ibid., section 2(4). Sovereign immunity is thereby abrogated. Section 1(3). Cf. Scott, "The Context for Bankruptcy Resolutions."

74. Appendix, section 3. No need to exclude the Federal Circuit Court of Appeals, as that circuit has no district judges.

75. Ibid.

from every judicial circuit, rather than funneling cases to the Second or DC Circuit, is responsive to likely political reactions by senators and representatives who focus on their own respective jurisdictions.) Moreover, the designated judge "goes with the case," so if venue is changed, the district judge will be deemed temporarily assigned to the new district.[76] Second, it requires two-entity recapitalization cases—those involving a section 1405 transfer—to be handled up to the point of the transfer by the designated district judge, but not necessarily thereafter (again, since most of the debtor's business has been transferred to the bridge company).[77] In other cases—conventional reorganization cases of the type contemplated by the original Chapter 14 1.0 proposal—the designated district judge, as with the *Bankruptcy Not Bailout* proposal, must keep the case and proceedings without referral to a bankruptcy judge.[78] Referral to a bankruptcy judge, however, can occur if there is a decision to convert the case to Chapter 7 pursuant to section 1112.[79] Third, the designated district judge can appoint a bankruptcy judge to assist the district judge as a special master.[80] Finally, because some circuits require that appeals from bankruptcy judges go to the Bankruptcy Appellate Panel (consisting of non–Article III bankruptcy judges), and the remaining circuits may otherwise send appeals to other district judges, this provision will require 28 USC section158(a) appeals from bankruptcy judges to go to the designated district judge.[81] (As usual, appeals from the designated district judge in cases and proceedings that haven't been referred to a bankruptcy judge will go to the relevant court of appeals.)

Role of Regulators

In addition to the Board's ability to file what is tantamount to a voluntary petition, as discussed above, Chapter 14 2.0 provides several

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76. Ibid.
77. Ibid.
78. Ibid.
79. Ibid.
80. Ibid.
81. Ibid.

other roles for regulators.[82] First, it gives the Board standing to be heard on any issue relevant either to the regulation of the debtor by the Board or to the financial stability of the United States.[83] It gives the FDIC more limited standing—to be heard in connection with a section 1405 transfer.[84] And it gives the primary financial regulator of any subsidiary (domestic or foreign) or its parent standing to be heard on any issue relevant to its regulation of that entity (including transfer of its ownership interests in a section 1405 transfer as well as its ownership by the debtor in a reorganization rather than a two-entity recapitalization).[85] If there is a section 1405 transfer, where the bridge company effectively continues as the recapitalized debtor (in a two-entity recapitalization), the Board's regulatory interest should shift to the bridge company, so Chapter 14 provides that, after such a section 1405 transfer, the Board's remaining standing vis-à-vis the debtor is with respect to its equity ownership of the bridge institution.[86] If there is not a section 1405 transfer, the Board, analogous to the primary regulator in the original Chapter 14 proposal, can file a plan of reorganization at any time. (In the typical section 1405 transfer, we propose the appointment of a trustee immediately after the section 1405 transfer, and thus all parties in interest, including the Board, are authorized to file a plan of reorganization without delay under section 1121(c) of the Bankruptcy Code.)[87]

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82. References to the United States trustee as having a role are removed (Appendix, section 2(2)), and our proposal essentially substitutes the (Federal Reserve) Board (a defined term from Appendix, Section 2(3)), thus, for example, giving the Board the power to move for the appointment of a trustee under section 1104. While Chapter 14 1.0 had provisions to give the primary regulator a role in the Chapter 14 proceeding, nothing exactly parallel to this exists in the Chapter 14 2.0 proposal. Appendix, section 2(5), follows, and modifies, the "regulator standing" proposal from Chapter 14 1.0.

83. Appendix, section 2(5).

84. Ibid.

85. Ibid.

86. Ibid.

87. Ibid.

Provisions Related to Making the Section 1405 Transfer Effective

As noted, at the heart of the two-entity recapitalization are two principles: first, that there is sufficient long-term unsecured debt—capital structure debt—to be "left behind" in the transfer to a bridge company so as to effectuate the recapitalization; and, second, that the bridge company otherwise have the assets, rights, and liabilities of the former holding company. A number of provisions in Chapter 14 2.0 are designed to effectuate this latter principle.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts.[88] Conceptually, the goal of these provisions is to keep assets and liabilities in place so that they can be transferred to the bridge company (within a forty-eight-hour window) and, thereafter, remain in place so that business as usual can be picked up by the bridge company once it assumes the assets and liabilities. This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a Chapter 14 case or similar circumstance, including credit-rating agency ratings), and it requires overriding similar provisions allowing for termination or modification based on a change of control, since the ownership of the bridge company will be different than the ownership of the debtor prior to the bankruptcy filing.[89] It needs to be broader than section 365 of the Bankruptcy Code, for at least two reasons. First, bankruptcy doesn't have a provision expressly allowing for the transfer of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected") upon the filing of a petition in bankruptcy. But, if there is going to be a two-entity recapitalization, the bridge company needs to take the debt "as if nothing has happened." Thus, Chapter 14 2.0 has provisions (sections 1406

88. See generally Appendix, sections 2(7) and (8).
89. Ibid.

and 1407) that are designed to accomplish that.[90] Second, section 365 doesn't deal with change-of-control provisions; these provisions add that and extend it to debt agreements as well.[91]

A complexity is that the brief stay to allow the section 1405 transfer needs itself to be terminated with respect to the termination or modification of any debt agreement if there is no section 1405 transfer but, rather, a regular bankruptcy of the type contemplated by the original Chapter 14 proposal.[92] (Debts—liabilities that normally are deemed breached upon the filing of bankruptcy—are in this respect treated differently than executory contracts and unexpired leases, since the provisions of sections 362 and 365 of the Bankruptcy Code are expected to continue, as they do in other reorganization cases.)

With respect to qualified financial contracts, similar rules apply. If there is a filing with a motion for a section 1405 transfer, there is a stay of efforts to liquidate, terminate, or accelerate a qualified financial contract of the debtor or subsidiary or to offset or net out, other than rights that exist upon the normal maturation of a qualified financial contract.[93] (Unlike the detailed provisions in the qualified financial contracts proposal in Chapter 14 2.0, these provisions are distinct in that they apply rules that didn't apply—and continue not to apply—in the Chapter 14 1.0 reorganization proposal, particularly with respect to repo counterparties and their ability to sell cash-like collateral.)

The stay applies for the period essentially until the section 1405 transfer occurs, it is clear it won't occur, or forty-eight hours have passed.[94] Because of this interregnum, when there is a likelihood that the section 1405 transfer will be approved, and all of these qualified financial contracts go over in their original form to the bridge company, there is a requirement that the debtor and its subsidiaries shall continue to perform payment and delivery obligations.[95] And,

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90. Ibid.
91. Ibid.
92. Ibid., section 2(7).
93. Ibid., section 2(8).
94. Ibid.
95. Ibid.

as long as the debtor and/or its subsidiaries are performing payment and delivery obligations, a counterparty is expected to comply with its contractual obligations as well; the failure to do so shall constitute a breach in accordance with the terms of the qualified financial contract.[96] Finally, if the filing of the bankruptcy case does not involve a motion for a section 1405 transfer, or if the motion is denied, or if forty-eight hours pass, then the case will be considered to be a conventional reorganization case (rather than a two-entity recapitalization case), and thus the original proposed rules for qualified financial contracts in Chapter 14 1.0 shall come into play.[97]

Just as the principle of having the bridge company have the same rights, assets, and liabilities drives the provisions regarding debts, executory contracts, and unexpired leases just discussed (including qualified financial contracts), a similar provision is necessary to keep licenses, permits, and registrations in place, and does not allow a government to terminate or modify them based on an ipso facto clause or a section 1405 transfer.[98]

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96. Ibid.

97. Ibid. These provisions are somewhat complex. To summarize them, without every nuance, under our provisions, from Chapter 14 1.0, we treat repos as debts, and consider them automatically breached by the commencement of the case. (Although there may be a stay up to forty-eight hours, if there is a motion for a section 1405 transfer, as described above.) However, we allow a counterparty to dispose of highly liquid collateral in its possession and exercise set-off rights without court permission, and allow it to sell other, non-firm-specific collateral in its possession upon motion to the court and the court's determination of the collateral's value. We also give the counterparty the right to reach comparable collateral in the hands of the debtor on motion of the court. We treat most swaps/derivatives as executory contracts, and give the debtor seventy-two hours to decide to accept or reject them (without permitting cherry-picking within a counterparty's portfolio). If they are accepted, then the swap/derivative continues as an enforceable contract, notwithstanding ipso facto clauses and the like. If they are breached, then the swap/derivative counterparty has essentially the rights of a repo counterparty (i.e., to sell highly liquid collateral, etc.).

98. Ibid., section 2(10). We assume that the "name" of the bridge company will be close enough to that of the debtor that filed financing statements will remain effective under Article 9, Section 9-508, of the Uniform Commercial Code.

Many avoiding power provisions use as a baseline what a creditor would receive in a Chapter 7 liquidation. That potentially brings into play various avoiding powers, such as preference law, against holders of short-term debt (such as commercial paper) who, in a Chapter 7 liquidation, might not be paid in full, but in a two-entity recapitalization under a section 1405 transfer, will be paid in full. Thus, section 1411 is designed to call off avoiding powers (other than section 548 (a)(1)(A) of the Bankruptcy Code dealing with intentional fraud) in the case of a section 1405 transfer, except with respect to transfers to, or for the benefit of, holders of long-term unsecured debt or subordinated debt (which is not transferred and is likely not to be paid in full) and transfers to the debtor's equity holders (such as dividends made prebankruptcy while the SIFI was insolvent).[99]

Finally, while all of these provisions deal with those in a relationship with the holding company, similar provisions need to be implemented with respect to contracts and permits held by a subsidiary whose ownership interests are transferred to the bridge company. Thus, we provide that a counterparty to such contracts with the subsidiary cannot terminate, accelerate, or modify any executory contract, unexpired lease, or debt agreement based on either an anti-assignment provision or a change-of-control provision.[100] Nor may a party to an agreement

99. Appendix, section 2(12). In an ordinary recapitalization case (not involving a section 1405 transfer), there are special avoiding power rules specified in Chapter 14 1.0 for holders of qualified financial contracts. Those provisions have been incorporated in Appendix, section 2(12) as well.

100. Ibid., Section 2(9). While these provisions affect the contracts of entities not themselves in bankruptcy, we believe they are fully authorized, if not by Congress's Article I bankruptcy power, then by application of the "necessary and proper" clause of Article I, as interpreted since McCulloch v. Maryland, 4 Wheat. 316 (1819). See also United States v. Comstock, 560 U.S. 126 (2010). The issue of reaching foreign subsidiaries cannot be directly resolved by US bankruptcy law and, in general, cross-border issues of international institutions remain nettlesome. See Jacopo Carmassi and Richard Herring, "The Cross-Border Challenge in Resolving Global Systemically Important Banks," chapter 9 in this volume. That said, domestic and foreign regulators and banks, in conjunction with the International Swaps and Derivatives Association (ISDA), have promulgated a Resolution Stay Protocol that will (with sufficient regulatory support) impose similar rules

with a subsidiary enforce a cross-default provision involving the debtor for the period during which a section 1405 transfer motion is under consideration.[101] Again, these provisions, like sections 1406 and 1407, are designed to allow the two-entity recapitalization effected by a section 1405 transfer to occur seamlessly with respect to the bridge company's ownership of the debtor's subsidiaries. Similarly, in the case of a subsidiary whose ownership is transferred to the bridge company in a section 1405 transfer, those licenses, permits, and registrations cannot be terminated based on a "change-of-control" provision.[102]

Transitional Provisions Designed to Make the Section 1405 Transfer Effective

Upon consummation of a section 1405 transfer, the newly created bridge company will have little to no long-term unsecured debt (as capital structure debt has been left behind with the debtor). It will, however, presumably have residual (equity) value—which is, indeed,

on qualified financial contract counterparties in major foreign jurisdictions (as well as the United States). See ISDA, "Resolution Stay Protocol—Background," October 11, 2014; see also Tom Braithwaite and Tracy Alloway, "Banks Rewrite Derivative Rules to Cope with Future Crisis," *Financial Times*, October 7, 2014. There are two points to note about the ISDA Resolution Stay Protocol. First, it does not supplant the need for the provisions in proposed sections 1407 and 1408. They originally apply (as of January 1, 2015) to eighteen major financial institutions and certain of their affiliates, although this is described as "[t]he first wave of banks." Second, they are, in principle, voluntary, although the eighteen financial institutions have committed themselves to the Protocol, and there are expectations that governmental regulators, who pushed for the ISDA Protocol, will make compliance effectively necessary. The provisions of sections 1407 and 1408 apply irrespective of whether a particular financial institution is bound to the ISDA Resolution Stay Protocol. See Scott, "The Context for Bankruptcy Resolutions." Second, to the extent that an institution *is* subject to the ISDA Resolution Stay Protocol, and foreign regulators recognize a Chapter 14 resolution proceeding, the Protocol will go a long way to resolving the inability of US bankruptcy law to impose, at least vis-à-vis derivatives, the provisions of section 1408 directly on foreign subsidiaries (and their counterparties) of a covered financial corporation that is in Chapter 14.

101. Appendix, section 2(9).

102. Ibid, section 2(10).

the basis ultimately for payment to the debtor's claimants that were not transferred to the bridge company. Whether the bridge will be able to meet legal and regulatory capital requirements with that equity value alone will depend both on ex post valuation and on whether the regulatory scheme requires (as we believe it must in order to effectuate a two-entity recapitalization in the first place) a certain amount of debt (and not just equity) for loss absorbency purposes. The bridge will initially have substantial capital (equity) on a book basis, but its initial book value may not be validated by market performance. Moreover, initially the bridge company will have little to no long-term unsecured debt—since capital structure debt was left behind—and such debt may be crucial in terms of regulatory requirements.[103] The equity value in market terms will need to be sufficient for the bridge company, over time, to issue new long-term unsecured debt, but until that occurs, the bridge company is likely to be non-compliant with the debt side of minimum capital requirements. Thus, Chapter 14 2.0 proposes giving the bridge company a window in which it does not have to be in compliance with those capital requirements. That period of effective exemption from those capital requirements ends at the earlier of (a) the confirmation of the debtor's plan of reorganization involving (as will usually be the case) the distribution of securities (or proceeds from their sale) of the bridge company or (b) the passage of one year from the section 1405 transfer.[104] By the end of that window of exemption, the bridge company must be in compliance with relevant regulatory capital requirements, including those involving minimum long-term unsecured debt.

Section 1145 of the Bankruptcy Code allows a reorganized debtor to issue securities pursuant to a plan of reorganization without complying with most securities laws, the idea being that the required disclosure in a plan of reorganization, under section 1125, confirmed by a court, should substitute. Given that an envisioned end of a bankruptcy case of a debtor where there has been a section 1405 transfer will be the sale or distribution of securities of the bridge company

103. Ibid, section 2(11).
104. Ibid.

pursuant to a plan of reorganization, section 1412 treats this situation as equivalent to the typical reorganization case involving securities of the debtor, and thus provides that a security of the bridge company shall be treated as a security of a successor to the debtor under a plan of reorganization, in cases where the court has approved the plan's disclosure statement as providing adequate information about the bridge company and the security—thus fitting it within the provisions of section 1145.[105] Additionally, the exemption from any law imposing a stamp tax or similar tax, in section 1146(a), applicable to securities issued pursuant to a conventional plan of reorganization, is provided to securities of the bridge company in connection with a confirmed plan of reorganization following a section 1405 transfer.[106] (Importantly, unlike the ill-advised provision in Title II of Dodd-Frank that treats a bridge financial institution as equivalent for a government entity not subject to federal, state, or local tax,[107] there is no comparable provision for the bridge company created in a section 1405 transfer. It is, and should be thought of as, a private company subject to no favorable tax considerations not applicable to its competitors. This is distinct from the issue of a holding company's tax loss carry-forwards that should be treated as an asset that can be transferred to the bridge company in the Section 1405 transfer.)

If there is a section 1405 transfer, the management, at least originally, of the bridge company is very likely to be the management of the entity that filed for bankruptcy. Given that, it would be a conflict of interest to have that same management having the status of the "debtor in possession" of the debtor, which is now the equity owner of the bridge company. As a consequence, and given (as noted in the prior numbered paragraph) that the debtor after the section 1405 transfer isn't likely to be operating an ongoing business, there really is no need for prior management to be the "debtor in possession."

Thus, section 1414 requires the replacement of the debtor in possession with a trustee, appointed by the court after a notice and

105. Ibid, section 2(13).
106. Ibid.
107. Dodd-Frank Act, section 210(h)(10).

hearing, who shall be chosen from a preapproved list of trustees.[108] This trustee will represent the estate before the judge, together with a creditors' committee (consisting of representatives of the holders of capital structure debt), an equity holders committee (consisting of representatives of the former equity owners of the debtor), and other parties in interest.[109] The appointment of the trustee will also, importantly, permit "a party in interest" to file a plan of reorganization without needing to wait out (or call off) the exclusivity period for the debtor in possession in section 1121(c) of the Bankruptcy Code. In cases not involving a section 1405 transfer—that is to say, cases involving a conventional reorganization as contemplated by the Chapter 14 1.0 proposal—this will permit, but not require, the appointment of a trustee, but if a trustee is appointed, it will be from the same preapproved list.[110]

In addition, because of the concern that the Chapter 14 trustee will be subject to conflicting pressures from his constituents (debt and equity left behind) concerning using the equity ownership of the bridge company to direct the bridge company's actions, which would be resolved by the judge overseeing the bankruptcy case, Chapter 14 2.0 places the actual equity interests of the bridge in the hands of a special trustee, appointed by the court at the time of the section 1405 transfer. The special trustee will hold the equity interests for the sole benefit of the Chapter 14 estate. This additional step, albeit a complicating feature, is designed to give third parties additional assurance that the bridge company is, indeed, not being run by an entity in bankruptcy or by the judge overseeing the Chapter 14 case. The special trustee will have ongoing reporting requirements to the Chapter 14 trustee; major corporate decisions that require equity input or approval can be taken by the special trustee only after consultation with the Chapter 14 trustee. The bridge company shall be responsible for paying the reasonable expenses of the special trustee.

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108. Appendix, section 2(15).
109. Ibid.
110. Ibid.

In the situation of a Chapter 14 case where there is a two-entity recapitalization pursuant to a section 1405 transfer, resolution of the Chapter 14 case will involve the debtor essentially awaiting a sale or distribution of equity securities of the bridge company that will be valued by the market. This distribution of stock or proceeds from it will form the basis of a plan of reorganization, including disclosure, solicitation of acceptances, a court hearing, and court confirmation of the plan (sections 1123–1129 of the Bankruptcy Code). While the Bankruptcy Code does not expressly provide a timetable for these events, it seems appropriate, given the hoped-for market-based determination of the value of the bridge company's equity securities that will be distributed in a plan, together with the desire to conclude the bankruptcy case (and wind down the debtor), to authorize explicitly a rapid time frame for solicitation, voting, and the court's hearing (and decision) on confirmation of the plan.[111]

Interface with Title II of Dodd-Frank

Currently, in order to commence an orderly liquidation proceeding under Title II of Dodd-Frank against a "covered financial company," where the board of that company does not acquiesce or consent to the proceeding, the secretary of the treasury must petition the District Court for the District of Columbia.[112] The court is given twenty-four hours to determine that the secretary's findings (a) that the "covered financial company is in default or in danger of default" or (b) that the company "satisfies the definition of a financial company under section 2019a)(11)" are arbitrary and capricious; if the court does not make a determination within that time frame, Dodd Frank provides that the petition is granted by operation of law.[113]

Given this very tight timetable, and given that if a Chapter 14 case was previously commenced there is already an involved district judge, the revised Chapter 14 proposal would amend Dodd-Frank by substituting the Chapter 14 district court (and judge) for the District

111. Ibid., section 2(16).

112. Dodd-Frank Act, section 202(a)(1)(A)(i).

113. Ibid., section 202(a)(1)(A)(v).

Court for the District of Columbia.[114] It would, in addition, subject the finding required of the government agencies under Dodd-Frank section 203(a)(2) that bankruptcy is not a viable alternative for the resolution of the financial institution to the same determination and issuance procedures currently outlined under section 202(a)(1)(A)(iii) and (iv) for the section 202(a)(1)(A)(iii) determination "that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under section 201(a)(11)."[115]

APPENDIX
Proposed Bankruptcy Code Chapter 14 2.0

Section 1: General Provisions Relating to Covered Financial Corporations

1) Amend **Section 101** of the Bankruptcy Code by adding a new subsection defining a "covered financial corporation" as any corporation that is substantially engaged in providing financial services or financial products (other than financial market infrastructure corporations such as central counterparty clearinghouses), and any subsidiary of that corporation that both (i) is substantially engaged in providing financial services or financial products and (ii) is neither (a) an entity, other than a domestic insurance company, that is included on the lists in Section 109(b)(2) and (b)(3)(B) nor (b) a stockbroker (Section 741) nor (c) a commodity broker (Section 761).

2) Amend **Section 103** of the Bankruptcy Code to provide that (a) except as provided in Chapter 14, Chapters 1, 3, and 5 of the Bankruptcy Code apply in a case under Chapter 14 and (b) the provisions of Chapter 14 apply only in a case where the debtor is a covered financial corporation. Also, amend Section 103 to provide that, except as

114. Appendix, section 4 (amending Dodd-Frank Act, section 202(a)(1)(A)(i)).

115. Dodd-Frank, section 203(a)(2) (the FDIC and the Board must both "contain . . . (F) an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company. . . .").

provided in Chapter 14, the provisions of Chapter 11 apply in a case under Chapter 14.

3) Amend **Section 106** of the Bankruptcy Code by adding Section 1403 to the list of sections where sovereign immunity is abrogated.

4) Amend **Section 109** of the Bankruptcy Code to provide that only a covered financial corporation may be a debtor under Chapter 14. Also, exclude the ability of a covered financial corporation to be a debtor under Chapter 11 or under Chapter 7 (unless, in the case of Chapter 7, it is pursuant to the application of Section 1112 in the Chapter 14 case).

5) Amend **Section 1506** of the Bankruptcy Code to provide that the court has the discretion not to enforce foreign home country stay orders, or not to issue orders barring domestic ring-fencing actions against US-based assets, if the foreign home country has not adopted comparable provisions respecting ancillary proceedings in that foreign home country for U.S.-based home proceedings.

Section 2: Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation

1) Amend the Bankruptcy Code by adding a new **Chapter 14** ("Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation").

2) Add a **Section 1401**, "Inapplicability of other sections," that provides that Sections 321(c) (allowing the U.S. trustee for the district to serve as a trustee) and 322(b) (essentially the same) do not apply to a case under Chapter 14. References to "the United States trustee" in Chapter 11 shall be deemed replaced by references to "the Board" (defined below).

3) Add a **Section 1402**, "Definitions for this chapter," that defines (a) the "Board" as referring to the Board of Governors of the Federal Reserve System, (b) "bridge company" as the recipient of the transfer under Section 1405, whose equity interests are received by the Chapter 14 debtor in that transfer, (c) "capital structure debt" as unsecured debt (including the under-secured portion of secured debt that would otherwise constitute capital structure debt), other than a qualified financial contract, of the debtor for borrowed money with an original

maturity of at least one year that is either (i) of a kind required by the Board or other applicable government agency, (ii) contractually subordinated to other unsecured debt, or (iii) convertible upon specified financial events or conditions to a security that would have a lower priority in bankruptcy than unsecured debt; (c) "qualified financial contract" as contracts as defined in Section 101(25), (38A), (47), or (53B), Section 741(7), or Section 761(4), (5), (11), or (13); (d) "special trustee" as the trustee of a trust created under Section 1405.

4) Add a **Section 1403**, dealing with the "Commencement of a case concerning a covered financial corporation," that permits a case to be commenced (a) by the filing of a voluntary petition by the debtor under Section 301, (b) in the case of a covered financial corporation as to which the Board has supervisory authority, by the Board if the Board certifies that it has determined, following consultation with the Secretary of the Treasury and the FDIC, that the immediate commencement of a Chapter 14 case is necessary to avoid serious adverse effects on the financial stability of the United States or that the covered financial corporation has substantial impairment of regulatory capital, or (c) in the case of other covered financial corporations, by the filing of a petition by the primary regulator of that corporation if the primary regulator certifies that it has determined that the covered financial corporation's assets are less than its liabilities, at fair valuation, or the covered financial corporation has unreasonably small capital. A filing by the Board under (b) or by the primary regulator under (c) with the requisite certification will be treated as equivalent to a Section 301 voluntary filing (that is, the commencement of the case will itself constitute an order for relief), except that, analogous to Section 303(i)(2)(A), the court, before or after a Section 1405 transfer, would retain jurisdiction so as, on motion and hearing, to determine any damages proximately caused by such a filing or transfer pursuant to Section 1405, if the court further makes the determination that the certifications required by either Section 1403 or Section 1405 were not supported by substantial evidence on the record as a whole.

5) Add a **Section 1404**, "Regulators," permitting (a) the Board to be heard on any issue relevant to the regulation of the debtor by the

Board or to financial stability in the United States, (b) the FDIC to be heard in connection with a transfer under Section 1405, (c) the primary financial regulatory agency (as defined in section 2(12) of Dodd-Frank) of the covered financial corporation, any subsidiary of the covered financial corporation, or the primary financial regulator of any foreign subsidiary of the covered financial corporation or its parent, to be heard on any issue relevant to its regulation of that entity. If there is a transfer under Section 1405, following that transfer, the Board can be heard only in connection with the debtor's ownership of the bridge company. If there is not a transfer under Section 1405, then the Board is deemed a party in interest who can file a plan of reorganization at any time after the later of (a) the order for relief and (b) the failure to timely approve of a transfer under Section 1405, in a case where such transfer is sought.

6) Add a **Section 1405**, "Special Transfer of Property of the Estate, Contracts, and Debts." On motion by the debtor, the Board, or the primary regulator (in the latter two cases, only if the Board or the primary regulator was eligible to file a petition under Section 1403) at the time of the commencement of the case, and after a hearing, the court may order a transfer of the property of the estate, executory contracts, unexpired leases, and debt agreements, with the exception noted next, from the debtor to a bridge company. Neither capital structure debt nor equity interests may be transferred. All other assets and liabilities of the debtor shall be transferred to the bridge company if the court orders a transfer under this section. The transfer under this section shall specify that any debt for borrowed money that (a) is secured by collateral included in the transfer, (b) is not associated with a qualified financial contract, and (c) has an original maturity of at least one year, shall be non-recourse upon the transfer if the deficiency claim would otherwise constitute capital structure debt. Prior to the hearing, 24-hour electronic or telephonic notice shall be given to (a) the debtor, (b) the 20 largest holders of capital structure debt, (c) the Board and the FDIC (if the Board has supervisory authority over the debtor), and (d) each primary financial regulatory authority, whether US or foreign, of the covered financial corporation and any subsidiary whose ownership is proposed to be transferred, each of

whom have standing, with respect to its particular regulatory jurisdiction, concerning the motion for a Section 1405 transfer. After the hearing, the court may not order the transfer unless it finds (or the Board or the primary regulator, as the case may be, certifies to the court that it has found) that the bridge company provides adequate assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company. In addition, the court may not authorize the transfer to the bridge company unless it determines that the by-laws of the bridge company will allow a thirty-day period in which the debtor, with the approval of the Chapter 14 judge after notice and a hearing, can determine the composition of the board of the bridge company, notwithstanding the charter or by-laws of the bridge company or applicable nonbankruptcy law. A transfer under this section shall provide for the transfer to a special trustee, appointed by the court, of all of the equity securities of the bridge company to be held in trust for the sole benefit of the Chapter 14 estate, as well as the responsibility of the bridge company to pay the reasonable expenses of the special trustee. The court shall approve the trust agreement and shall require the special trustee to inform and consult with the Chapter 14 trustee about material corporate actions of the bridge company. The special trustee shall distribute the assets held in trust, and shall thereafter terminate the trust, upon either (a) the effective date of a confirmed plan of reorganization of the covered financial corporation or (b) the conversion of the case to Chapter 7. Finally, while the court otherwise does not retain jurisdiction over the bridge company following the transfer, it does retain jurisdiction for one year, on application by the bridge company, for liquidity financing at the priority levels of, and on the conditions specified in, Section 1413.

7) Add a **Section 1406**, dealing with "Automatic Stay; Assumed Debt." (I) Provide in this section that the filing of a petition operates as a stay, applicable to all entities, of the termination, acceleration, or modification of any debt agreement (other than a capital structure debt agreement or a qualified financial contract), executory contract (other than a qualified financial contract), or unexpired lease with the

debtor, or of any right or obligation under any such debt, contract, lease, or agreement, solely because of a provision that is conditioned on (a) the insolvency or financial condition of the debtor at any time before the closing of the case; (b) the commencement of a Chapter 14 case; (c) a cross-default, or (d) a change in a credit-rating agency rating (i) of the debtor at any time after the commencement of the case or (ii) of a subsidiary during the 48 hours after the commencement of the case, or (iii) of the bridge company or a subsidiary of the bridge company prior to the earlier of 90 days or the confirmation of a plan involving the debtor under Section 1129. The stay under this Section 1406 terminates, as to the debtor and with respect to any debt agreements with the debtor, upon the earliest of (a) a commencement of a Chapter 14 case without a motion for a Section 1405 transfer, (b) 48 hours after the commencement of the case, (c) the transfer of the debt agreement under an order authorizing a Section 1405 transfer, or (d) a determination by the court not to order a Section 1405 transfer. In addition, in the case of a subsidiary, the stay terminates not only upon the foregoing conditions but by a determination by the court not to order the transfer of the interests of the debtor in the subsidiary to the bridge company.

(II) Provide, as well, in this section, that such a debt agreement, executory contract, or unexpired lease of the debtor, may be transferred (and thus assumed) by the bridge company under Section 1405 notwithstanding any provision in an agreement or applicable non-bankruptcy law that (a) prohibits, restricts, or conditions the assignment of such debt agreement, executory contract, or unexpired lease, or (b) terminates, accelerates, or modifies any such debt agreement, executory contract, or unexpired lease, based on a change in control in any party.

8) Add a **Section 1407**, "Treatment of Qualified Financial Contracts," that provides that the filing of a petition to commence a Chapter 14 case that is accompanied by a motion for a Section 1405 transfer operates as a stay, notwithstanding Sections 362(b)(6), (b)(7), (b)(17), (b)(27), 555, 556, 559, 560, and 561, for the period specified in the stay duration in Section 1406, above, of the exercise of any contractual

right (i) to liquidate, terminate, or accelerate a qualified financial contract of the debtor or a subsidiary or (ii) to offset or net out any termination value, payment amount, or the like except the exercise of contractual rights that arise upon the non-accelerated maturity of a qualified financial contract shall not be subject to the stay. During the period in which this Section 1407 stay is applicable, the debtor and its subsidiaries shall perform all payment and delivery obligations under a qualified financial contract that become due after the commencement of the case; if the debtor or a subsidiary, as the case may be, fails to perform any such obligation, the stay provided by this Section 1407 terminates. As long as the debtor and/or its subsidiaries are performing all payment and delivery obligations under a qualified financial contract that become due after the commencement of the case, the failure of a counterparty to perform its obligations under that qualified financial contract shall constitute a breach of such contact according to its terms. A Section 1405 transfer of a qualified financial contract to the bridge company may not occur unless (i) all qualified financial contracts between the counterparty and the debtor are transferred to the bridge company and (ii) all property acting as security to the qualified financial contract is likewise transferred to the bridge company. Upon the transfer of a qualified financial contract to the bridge company under Section 1405, notwithstanding any provision in the qualified financial contract or in applicable law, that qualified financial contract may not be terminated, accelerated, or modified, for a breach of a provision of the type identified in Section 1406 (I) between the time of the Section 1405 transfer until the conclusion of the Chapter 14 case involving the debtor. If there is not a request for a transfer under Section 1405, or if such transfer is not approved, or 48 hours from the filing of the petition have expired, then the provisions for qualified financial contracts originally outlined in "Chapter 14 version 1.0" in BANKRUPTCY *NOT* BAILOUT apply.

9) Add a **Section 1408**, "Subsidiary Contracts," that provides that, notwithstanding any provision in an agreement or applicable nonbankruptcy law, an agreement of a subsidiary (including an executory contract, unexpired lease, or agreement under which the subsidiary issued or is obligated for debt) where the subsidiary's ownership

interests that are property of the estate are transferred to the bridge company in a Section 1405 transfer, such agreement may not be terminated, accelerated, or modified, at any time after the commencement of the case, because of a provision prohibiting, restricting, or conditioning the assignment of the agreement or because of the change-of-control of a party to the agreement. Nor may a cross-default provision respecting the debtor in an agreement of the subsidiary be enforced in any case of the debtor involving a Section 1405 transfer motion during the earliest of 48 hours from the commencement of a case under this Chapter involving the debtor or the denial of a Section 1405 transfer motion.

10) Add a **Section 1409**, dealing with "Licenses, Permits, and Registrations," that provides, notwithstanding any other provision of nonbankruptcy law, a Section 1405 transfer motion stays, for the period of time specified in Section 1406, any termination or modification of any Federal, State, or local license, permit or registration that the debtor or a subsidiary had immediately before the commencement of the case that is proposed to be transferred, based upon (i) the insolvency or financial condition of the debtor at any time before the closing of the case, (ii) the commencement of a case under this title, or (iii) a transfer under Section 1405. Following a Section 1405 transfer, all such licenses, permits, and registrations shall vest in the bridge company. In addition, where a subsidiary's ownership interests that are property of the estate are proposed to be transferred to the bridge company in a Section 1405 transfer, a Section 1405 transfer motion stays, for the period of time specified in Section 1406 and thereafter if the subsidiary's ownership interests that are property of the estate are transferred to the bridge company in a Section 1405 transfer, any termination or modification of any Federal, State, or local license, permit or registration that the subsidiary had immediately before the commencement of the case, based on a change-of-control of the subsidiary.

11) Add a **Section 1410**, "Bridge Company Capital Requirements," giving the bridge company an exemption from applicable debt or capital requirements (such as might be required by the Board or Basel III) until such time as (a) the confirmation of a plan of reorganization for the debtor that involves the distribution or sale of securities of

the bridge company or (b) one year from the Section 1405 transfer, whichever is earlier.

12) Add a **Section 1411**, "Avoiding Powers," providing that in a case where there is a request for a Section 1405 transfer, and such transfer occurs, the avoiding powers in Sections 544, 547, 548(a)(1)(B), or 549, do not apply, except for transfers of (i) an interest of the debtor in property to or for the benefit of a holder of capital structure debt under Section 547 or (ii) an interest of the debtor in property to or for the benefit of a holder of equity of the debtor under Section 548(a)(1)(B). Additionally, if there is not a motion for a Section 1405 transfer or if such transfer is not approved, the provisions for the application of avoiding powers with respect to qualified financial contracts contained in BANKRUPTCY *NOT* BAILOUT apply.

13) Add a **Section 1412**, "Exemption from Securities Laws and Special Tax Provisions," providing that, for purposes of Section 1145, a security of the bridge company shall be deemed to be a security of a successor to the debtor under a plan of reorganization if the court approves the disclosure statement for the plan as providing adequate information (as defined in Section 1125(a)) about the bridge company and the security. In addition, securities issued by the bridge company in connection with a confirmed plan of reorganization shall have the protection from any law imposing a stamp tax or similar tax under Section 1146(a).

14) Add a **Section 1413**, "Debtor-in-Possession Financing," that picks up the provisions regarding Section 364 in the original Chapter 14 version 1.0.[116]

15) Add a **Section 1414**, "Trustee in a Chapter 14 Case" that provides, if there is an approved Section 1405 transfer, then there shall be a trustee appointed by the court, after notice and a hearing, in lieu of the debtor in possession, for all purposes of the debtor after the Section 1405 transfer. The trustee shall be appointed by the court from a pre-approved list of trustees that has been determined by the Chief Judge of the Circuit. In other cases, a trustee, chosen from the

116. Pursuant to section 1405, these provisions will also be applicable to the bridge company. See section 2(6).

pre-approved list of trustees, can be appointed pursuant to the provisions of Section 1104.

16) Add a **Section 1415**, "Solicitation, Acceptance, and Confirmation of a Plan," providing that, in the case of a plan of reorganization proposed at or following the approval of a Section 1405 transfer, that a court may hold a confirmation hearing under Section 1128, within ten days of the circulation of the plan if voting for purposes of Section 1126 is sufficient, at the time of the hearing, to allow the court to make the determinations required by Section 1129.

Section 3: Amendments to Title 28

1) Provide, in **Section 298**, that, notwithstanding Section 295, the Chief Justice of the United States shall designate at least one district judge from each circuit to be available to hear a case under Chapter 14. And that district judge, again notwithstanding Section 295, shall hear a Chapter 14 case filed in that circuit, and shall be considered, for purposes of the case, to be temporally assigned to the district in which the bankruptcy case is commenced or any district to which the case is removed pursuant to 28 USC §1412. The district judge may not refer a motion for a Section 1405 transfer to a bankruptcy judge, notwithstanding Section 157. In a case in which there is not a motion for a Section 1405 transfer, or the motion is denied, the district court may not assign the case or proceedings under the case to a bankruptcy judge, unless there has been approved a motion to convert the case to Chapter 7 pursuant to Section 1112. In all cases where the district judge may not refer a case or proceeding to a bankruptcy judge, the district judge may appoint a bankruptcy judge as a special master. Appeals under Section 158(a) in a Chapter 14 case shall be heard by the assigned district judge.

Section 4: Amendment to Dodd-Frank Wall Street Reform and Consumer Protection Act

1) Amend **Section 202** by adding at the end of (a)(1)(A)(i) that, notwithstanding the provisions of this subsection, if a case has been commenced under Chapter 14 of Title 11, the relevant district court shall be the district court where the Chapter 14 case is pending, and

the judge overseeing the Chapter 14 case shall be assigned to hear and decide the order under (a)(1)(A) of this section. In addition, amend (a)(1)(A)(iii) and (iv) so as to subject the finding required of the government agencies under section 203(a)(2)(F) to the same determination and issuance procedures currently outlined under (a)(1)(A)(iii) and (iv) of this section for the (a)(1)(A)(iii) determination.

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JULY 29, 2015

Main Points

1. Some financial sector firms have become so large and so complex that handling any potential insolvency through standard bankruptcy procedures is difficult and costly. The precise distribution of losses across creditors and counterparties is hard to predict, often with unforeseen consequences around the globe. Such bankruptcy events can therefore have major destabilizing effects on financial markets and the real economy in the U.S. and internationally.[1]
2. The systemic risks posed by the failure of large complex financial institutions have been understood for several decades—and use of the term "too big to fail" in this context dates back at least to the 1980s.[2] But in mid-September 2008 the U.S. authorities took the view that the failure of Lehman Brothers could be handled through the bankruptcy courts and might even have a cathartic effect on the financial system. Within 24 hours of Lehman's bankruptcy, the leadership at the Treasury Department and the Federal Reserve Board of Governors realized that this was most definitely not the case—the negative spillover effects of Lehman's bankruptcy on the U.S. and global economies were huge.[3]
3. Lehman's bankruptcy led directly to the U.S. Government's bailout of AIG, a large insurance company, and to the unprecedented support provided to money market mutual funds. When this failed to stabilize the system, Goldman Sachs and Morgan Stanley were allowed to become bank holding companies, which increased their access to Federal Reserve support. The Troubled Asset Relief Program (TARP) was rushed through Congress and quickly became the largest injection of capital into private financial firms in the history of the United States. Additional unprecedented bailouts were provided to Citigroup in November 2008 and to Bank of America in January 2009. Further statements of guarantee were provided by top officials in February 2009, and a stress test process—assuring market participants that the Government believed leading banks had enough loss-absorbing equity—was conducted in spring 2009.
4. These and related enormous forms of selective Government support were not sufficient to prevent the most serious recession since the 1930s from which, after 7 years, the U.S. economy is still struggling to recover.[4]
5. There has long been a "resolution" process, run by the Federal Deposit Insurance Corporation (FDIC), that handles the insolvency of banks that have insured retail (i.e., small-scale) deposits. For over 70 years, the FDIC has protected insured depositors and not incurred any liability for taxpayers. Shareholders are often wiped out and bondholders face losses in FDIC resolution, in accordance with well-defined and transparent criteria. However, prior to 2010, this FDIC procedure could only be applied to banks with insured deposits.
6. In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title II of this Act created an Orderly Liquidation Authority that essentially broadened the mandate and powers of the FDIC to include the resolution of nonbank financial companies.[5]
7. However, this power is intended only as a back-up, in case bankruptcy is determined—by the Secretary of the Treasury, with the Federal Reserve and the

[1] Also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Research Advisory Committee, and the Systemic Risk Council (created and chaired by Sheila Bair). All the views expressed here are mine alone. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at *http://BaselineScenario.com.* For important disclosures, see *http://baselinescenario.com/about/*.

[2] See Gary Stern and Ron Feldman, "Too Big To Fail: The Hazards of Bank Bailouts", Brookings Institution Press, 2004.

[3] See Andrew Ross Sorkin, "Too Big To Fail: The Inside Story of How Wall Street and Washington Fought To Save the Financial System—And Themselves", Viking, 2009. The assets and liabilities of Lehman Brothers were just over $600 billion, about 4 percent of U.S. GDP.

[4] For a recent comprehensive and accurate assessment, see "The Cost of the Crisis: $20 Trillion and Counting", a report by Better Markets, July 2015. Massive Government assistance was provided to big banks and some other parts of the financial sector but not generally to the nonfinancial sector—and hardly at all to families who owed more on their mortgages than their homes were worth.

[5] See Section 204, creating the Orderly Liquidation Authority, and all related parts of Title II.

FDIC—to be infeasible or likely to cause unacceptable levels of collateral damage. Titles I and II of Dodd-Frank make it clear that all firms should be able to go bankrupt—and the point of the "living wills" process is to force firms to change in order to become resolvable through bankruptcy. (More on the difficulties of bankruptcy is in Section B below.)

8. Since 2010, the FDIC has developed a resolution strategy for large complex financial institutions in which there is likely to be single point of entry in the resolution of any group of firms under a bank holding company.[6] In this strategy, shareholders in the holding company would be wiped out (if the losses are large enough) and debt would be converted to equity—in order to recapitalize a new enterprise as a going concern, presumably without the activities that incurred the devastating losses. There would be a one day stay on creditors of all kinds.[7] There are also moves to end the automatic termination of derivative contracts in the event of resolution.[8] This is intended to give the FDIC time to complete the resolution process—and to allow operating subsidiaries to continue in business.
9. Repealing Title II of Dodd-Frank would be a mistake. Title II is a backstop, in case bankruptcy proves infeasible (see Section C below). Title II creates a clear mandate for advance planning for private sector firms and for officials, and makes it possible to create a structure for cross-border cooperation on resolution.[9]
10. At the same time, we should recognize that:
    a. Title I of Dodd-Frank requires credible living wills, in which firms would be able to fail through bankruptcy. We are a long way from having satisfactory living wills. Officials need to press harder on this front; more on this in Section C below.
    b. The largest and most complex financial firms need to become much simpler and, most likely, smaller in order for either bankruptcy to work (as required under Title I) or for the FDIC's single point of entry strategy to work (if Title II powers are used).
    c. The FDIC's primary resolution strategy relies on there being enough "loss-absorbing capital" at the holding company level. But only equity is really loss-absorbing. "Loss-absorbing debt" is an oxymoron—when creditors suffer major losses on a mark-to-market basis, there is real potential for a systemic panic, particularly as other related assets will be immediately reduced in value.
    d. We should be very concerned about the current international push towards a Total Loss Absorbing Capacity (TLAC) approach for bank holding companies.[10] We currently have only 4–5 percent equity (and 95–96 percent debt) in our largest bank holding companies.[11] Resolution as designed by the FDIC will likely not work in this scenario—the losses imposed on creditors will have serious systemic effects. Bankruptcy would be even more of a disaster. The result could easily be some new form of Government-sponsored

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[6] See "A Progress Report on the Resolution of Systemically Important Financial Institutions", speech by Martin J. Gruenberg, chairman of the FDIC; May 12, 2015. Mr. Gruenberg makes it clear that the single point of entry is only one option for the FDIC's approach to resolution.

[7] See "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements", by Darrell Duffie and David A. Skeel, *University of Pennsylvania Law School*, January 2012.

[8] This stay is supported by the International Swaps and Derivatives Association (ISDA) Resolution Stay Protocol, but the coverage of this is still incomplete—it currently only includes major banks, not "buy side" investors.

[9] The FDIC and the Bank of England have a memorandum of understanding on resolution-related issues; this would likely not apply if a large complex financial institution were to file for bankruptcy.

[10] This push is being led by the Financial Stability Board but it almost certainly represents a European attitude towards how to handle financial distress. Given that the European authorities are much more comfortable with continuing some version of Too Big To Fail—and providing bailouts to creditors under a wide variety of circumstances—it is most unwise to follow their lead on this matter.

[11] See the December 2014 edition of The Global Capital Index, produced by Thomas Hoenig, vice chairman of the FDIC. Mr. Hoenig converts U.S. GAAP accounts to their International Financial Reporting Standards (IFRS) equivalent, as this better reflects the risks inherent in derivative positions. The new reporting of risk exposures to the Fed (on FR Y-15) produces numbers that are similar to those of Mr. Hoenig. For example, in Mr. Hoenig's index, the largest bank in the world at the end of 2014 was JPMorgan Chase, with a balance sheet of $3.827 trillion (under IFRS); on its FR Y-15, JPMorgan Chase states its total risk exposure as $3.743 trillion.

bailout, through the Federal Reserve or through new powers granted by Congress (as happened in September 2008). It is imperative that officials move to greatly increase loss-absorbing equity in the largest, most complex financial firms (see Section D below). [12]

The Problem With Bankruptcy

There are two variants of the "bankruptcy-only" proposal. In both approaches, Title II of Dodd-Frank would be repealed—so the FDIC could not be involved in the failure of any bank holding company (or any financial firm, other than a bank with retail deposits).

In the first variant, the bankruptcy code would be modified, for example to grant the kind of automatic stay now available only under FDIC resolution, but there would be no debtor-in-possession financing provided by the Government.

The problem with this scenario is that it would be very difficult for a bankruptcy judge to enable any part of the financial firm to continue in business. The bankruptcy would be akin to complete liquidation or winding down, as was the case with Lehman Brothers. The losses to creditors in this scenario are large while the precise incidence of losses would take many years to determine fully. Under such an approach, the failure of a large complex financial institution would most likely result in chaos, along the lines experienced in September 2008.

In the second bankruptcy-only variant, proponents argue that debtor-in-possession financing should be provided by the Government—precisely because the private sector is highly unlikely to provide the scale of funding needed. To make this more palatable, this kind of funding is sometimes referred as a "liquidity" loan.

But providing large scale funding from the Government to a bankruptcy judge is both a bad idea economically and politically infeasible. Judges lack the experience necessary to administer such loans. In all likelihood, this would become a form of bailout that keeps existing management in place. To support a large complex financial institution, the scale of loans involved—from the Treasury or the Federal Reserve—would be in the tens of billions of dollars (in today's prices) and there would be a very real possibility of taxpayer losses. The extent of executive branch engagement and congressional oversight would be limited. Most likely there would be both scope for both genuine concern and a dangerous broader collapse of legitimacy.

It makes sense to examine ways to improve the bankruptcy code to make it easier for financial firms fail through bankruptcy—and this is completely consistent with making Title I of Dodd-Frank more effective. But any threats to rely solely on bankruptcy for the largest, most complex, and massively global firms are simply not credible. This would be the same kind of tactics that the Treasury resorted to under Hank Paulson in 2008—until the policy was dramatically reversed after the bankruptcy of Lehman Brothers. It was that reversal under President George W. Bush and President Barack Obama that created the modern expansive version of Too Big To Fail that haunts us still.

Bankruptcy cannot work for the largest and most complex banks at their current scale and level of complexity. This is not a viable option under current law for the largest bank holding companies with their current scale and structure, even if the law is tweaked to allow for a longer stay on creditors. And changing the law more dramatically to add a bailout component (or "Government-backed liquidity loans") to bankruptcy procedures—but only for very large complex financial institutions—would not lead to good outcomes.

Bankruptcy and Living Wills

Under current law—and as a matter of common sense—the Federal Reserve now needs to take the lead in forcing large complex financial institutions to become smaller and simpler.

The legal authority for such action is clear. Under section 165 of the 2010 Dodd-Frank financial reform legislation, large nonbank financial companies and big banks are required to create and update "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure." The intent is that this plan—known as a "living will"—should explain how the company could go through bankruptcy (i.e., reorganization of its debts under Chapter 11 or liquidation under Chapter 7 of the Bankruptcy Code), without causing the kind of collateral damage that occurred after the failure of Lehman Brothers.

[12] The Federal Reserve is moving capital requirements in the right direction, including with a higher requirement for loss-absorbing equity in the largest firms. But, as Mr. Hoenig's Global Capital Index shows, these buffers against losses remain very small relative to true risk exposures. For the integrated and persuasive case for higher capital requirements, see Anat Admati and Martin Hellwig, "The Bankers' New Clothes: What's Wrong With Banking and What To Do About It", *Princeton University Press*, 2013.

This bankruptcy should not involve any Government support. It is supposed to work for these large financial companies just like it works for any company, with a bankruptcy judge supervising the treatment of creditors. Existing equity holders are typically "wiped out"—meaning the value of their claims is reduced to zero.

The full details of these living wills are secret—known only to the companies and to the regulators.[13] But based on the publicly available information these living wills are not currently credible because the big banks remain incredibly complex, with cross-border operations, and a web of interlocking activities.[14] When one piece fails, this triggers cross-defaults, the seizure of assets around the world by various authorities, and enormous confusion regarding who will be paid what. All of these effects are exacerbated by the fact that these firms are also highly leveraged, with much of this debt structured in a complex fashion (including through derivatives).

What then are the implications? The Dodd-Frank Act has some specific language about what happens if "the resolution plan of a nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a) is not credible or would not facilitate an orderly resolution of the company".

Not unreasonably, under section 165 of Dodd-Frank, the Fed and the FDIC, "may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies."

The company may also be required, "to divest certain assets or operations identified by the Board of Governors and the Corporation, to facilitate an orderly resolution."

Some supporters of the big banks argue in favor of skipping bankruptcy and go directly to Title II resolution. But this Title II (of Dodd-Frank) authority is intended as a back-up—only to be used if, contrary to expectations, bankruptcy does not work or chaos threatens.

As it is currently obvious that bankruptcy cannot work, the legislative intent is clear. The Fed and the FDIC must require significant remedial action, meaning that something about the size, structure, and strategy of the megabanks must change and these changes must be sufficient to allow bankruptcy (without massive systemic damage) to become a real possibility.

Global Issues and the Need for Additional Capital Requirements

Writing in the March 29, 2011, edition of the National Journal, Michael Hirsch quotes a "senior Federal Reserve Board regulator" as saying:

> "Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems," and, "We think we're going to effectively resolve that using Dodd-Frank? Good luck!"

This regulator has a point.[15] The FDIC can close small- and medium-sized banks in an orderly manner, protecting depositors while imposing losses on shareholders and even senior creditors. But it is a stretch to argue that such a resolution authority will definitely "work"—i.e., prevent spillover systemic damage and negative impact on the real economy—for any failing large bank with significant cross-border operations.

The resolution authority granted under Dodd-Frank is purely domestic, i.e., it applies only within the United States.[16] The U.S. Congress cannot make laws that apply in other countries—a cross-border resolution authority would require either a treaty-level agreement between the various Governments involved or some sort of

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[13] Public portions of living wills are available on the FDIC Web site. Plans filed on July 1, 2015, show some progress towards more disclosure. But there is nothing in the latest published living wills that suggests bankruptcy is currently a plausible approach to the potential failure of the largest bank holding companies.

[14] For a glimpse into the complexity of corporate structures across borders within individual large complex global financial firms, see the corporate network visualizations available at *https://opencorporates.com* (e.g., for Goldman Sachs). As one global regulator reportedly has said, large banks live globally but die locally—so any bankruptcy (or resolution) has to sort out a myriad of intertwined obligations across multiple jurisdictions.

[15] Although it must be pointed out that Citigroup's total risk exposure at the end of 2014 was $2.766 trillion, substantially larger than the number mentioned by the official, who must have been thinking only about on-balance sheet assets. One lesson from the experience of 2007–08 and from the data now reported in FR Y-15 (Banking Organization Systemic Risk Reports, required by Dodd-Frank) is that we should think more in terms of total risk exposure.

[16] For a discussion of what would happen if global banks fail post-Dodd-Frank, see Marc Jarsulic and Simon Johnson, "How a Big Bank Failure Could Unfold", *NYT.com*, Economix blog, May 23, 2013.

synchronization for the relevant parts of commercial bankruptcy codes and procedures.

There are no indications that such treaties will be negotiated—or that there are serious inter-governmental efforts underway to create any kind of cross-border resolution authority, for example, within the G20. [17]

The best approach for the United States today would be to make all financial institutions small enough and simple enough so they can fail—i.e., go bankrupt—without adversely affecting the rest of the financial sector. The failures of CIT Group in fall 2009 and MF Global towards the end of 2011 are, in this sense, encouraging examples. But the balance sheets of these institutions were much smaller—about $80 billion and $40 billion, respectively—than those of the financial firms currently regarded as Too Big To Fail.

To the extent that the authorities are unwilling or unable to make some banks smaller and simpler, they should substantially increase the required amount of loss-absorbing equity for those firms. [18] Concerns about complexities associated with the failure of cross-border operations also strengthen the case for higher capital requirements (in the form of loss-absorbing equity, not an illusory TLAC requirement).

[17] The Memorandum of Understanding between the FDIC and the Bank of England is helpful in this regard but unlikely to prove sufficient to eliminate significant cross-border difficulties in the event of the failure of a large complex financial institution. This understanding also only applies in the case of FDIC resolution; it would not apply in the event of bankruptcy (i.e., without FDIC involvement).

[18] Senators Sherrod Brown and David Vitter have proposed a scale for capital requirements, with greater focus on the leverage ratio (i.e., less value attached to the importance of risk-weights), that would increase steeply for the largest and most complex financial institutions. This is a promising approach that deserves further legislative and regulatory attention. Given the issues with bankruptcy and resolution, discouraging scale and complexity makes sense. For further discussion, see Simon Johnson and James Kwak, *13 Bankers*, Pantheon, 2010.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER FROM THE NATIONAL BANKRUPTCY CONFERENCE SUBMITTED BY SENATOR MERKLEY

NATIONAL BANKRUPTCY CONFERENCE

A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

June 18, 2015

Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Honorable Chuck Grassley
Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510

Honorable Hank Johnson
Ranking Member,
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Honorable Patrick J. Leahy
Ranking Member
Committee on the Judiciary
United States Senate
Washington, DC 20510

Re: **Proposed Amendments to Bankruptcy Code Relating to Resolution of Systemically Important Financial Institutions**

Dear Reps. Marino and Johnson and Sens. Grassley and Leahy,

The National Bankruptcy Conference (**NBC**) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for nearly 80 years. I enclose a Fact Sheet, which provides further information about the NBC.

In 2013 and 2014, two bills were introduced to amend the Bankruptcy Code to add special procedures for the resolution of systemically important financial institutions ("**SIFIs**")—the Taxpayer Protection and Responsible Resolution Act, S. 1861 ("**TPRRA**"), which would have added a new chapter 14 to the Bankruptcy Code, and the Financial Institution Bankruptcy Act of 2014, H.R. 5421 ("**FIBA**"), which would have added a new subchapter V to chapter 11 of the Bankruptcy Code. The Senate did not take any action on TPRRA. FIBA was passed by the House just before adjournment of the 113th Congress, on December 1, 2014.

In a letter dated January 29, 2014 to Senators John Cornyn and Pat Toomey, the Conference commented on TPRRA (the "**NBC TPRRA Letter**"). Later in 2014, members of the Conference's Capital Markets Committee met with the House Judiciary Committee staff to provide technical comments regarding FIBA, but the Conference did not provide written comments regarding FIBA. Because bills similar to TPRRA and FIBA might be introduced in the current Congress, the Conference wants to provide several additional comments regarding certain aspects of TPRRA and FIBA, and more generally on the subject of the resolution of SIFIs in a bankruptcy case.

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The Conference appreciates the efforts of the last Congress to improve the Bankruptcy Code to facilitate the resolution of SIFIs. However, the problems entailed in resolving a SIFI in a bankruptcy case are very difficult, and, under the proposals introduced during the last Congress, could be intractable. While TPRRA and FIBA offered tools to address some of these problems (for example, by facilitating the use by SIFIs of single point of entry recapitalization[1] and by limiting early termination rights in qualified financial contracts if certain conditions are met), other obstacles and issues were not addressed at all or were not addressed adequately in either of the bills.

The Conference has a number of significant concerns, including the following:

- Generally, the Conference believes a bankruptcy process might not be best equipped to offer the expertise, speed and decisiveness needed to balance systemic risk against other competing goals in connection with resolution of a SIFI. The Conference strongly believes that laws in place with regard to a regulator-controlled SIFI resolution process, like the Federal Deposit Insurance Act ("**FDIA**") and Orderly Liquidation Authority under Title II of the Dodd-Frank Act ("**OLA**"), should continue to be available even if special provisions are added to the Bankruptcy Code to attempt to facilitate the resolution of SIFIs in bankruptcy. The Conference accordingly opposes provisions that would suspend or limit the powers regulators now possess with regard to the resolution of SIFIs.

- For similar reasons, the Conference believes regulators should be afforded significant involvement in and supervision over the ongoing operations of a SIFI being resolved in a bankruptcy case. Regulators should have the authority to appoint a trustee and to closely supervise and, if necessary, specify limitations and conditions on the ongoing operations of the firm. The Conference believes that any amendments to the Bankruptcy Code relating to the resolution to SIFIs should make it clear that regulators have these powers despite the pendency of the bankruptcy.

- On the other hand, while the Conference believes regulators should have a more significant role in a SIFI's bankruptcy, the Conference believes regulators should not be granted authority to commence a bankruptcy case against a SIFI. FIBA, which provided the Federal Reserve with authority to file an involuntary petition against a SIFI, made clear that, as practical matter, there would be no meaningful opportunity to contest such a petition or to appeal entry of the order for relief. While the Conference considered the possibility of authorizing regulators to file ta *voluntary* petition on behalf of a SIFI, the Conference concluded that a regulator's ability to exercise its

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[1] Of course, effective recapitalization as an element of SPOE requires a firm to have a sufficient amount of loss absorbing unsecured debt that is contractually or structurally subordinated to operating liabilities of the SIFI (for example, unsecured debt issued by the firm's bank holding company). Requirements to maintain such debt are expected be established by the Federal Reserve's proposed rule establishing the nature and amount of the unsecured subordinated debt at the holding company level that is necessary to make SPOE effective.

authority under the FDIA, SIPA, OLA and other special resolution regimes would provide a sufficient incentive for a SIFI to timely commence a voluntary bankruptcy case.

- The Conference believes that any procedure contemplating use of bankruptcy proceedings to recapitalize a SIFI should not include provisions, like those in TPRRA, limiting the availability of lender-of-last-resort liquidity for a recapitalized firm and in fact should include provisions to facilitate making lender-of-last-resort interim liquidity, on a fully secured basis, available to all members of the SIFI group, including the bank and broker-dealer operations of the recapitalized firm.

- The Conference believes that a bankruptcy case for resolving a SIFI, like any other reorganization case, should be handled by a bankruptcy judge with expertise reorganizing insolvent firms, not by a district judge, and the Conference supports both the appointment of panels of judges who can develop the necessary relevant expertise and a judicial selection process like the one contained in FIBA.

We address each of the above concerns in greater detail below.

Existing Non-Bankruptcy Resolution Regimes Should Not Be Repealed

As a preliminary observation, the Conference notes that in virtually all countries, including the United States, regulators have historically controlled the process of resolving distressed banks. In the United States, for example, insured depositary institutions have been resolved by the Federal Deposit Insurance Corporation (FDIC) under the FDIA. On the other hand, until recently, the involvement of national regulators in the resolution procedures for bank holding companies and broker-dealers has been less uniform. In the United States, for example, the bankruptcy of a bank holding company has been addressed using a conventional bankruptcy case under the Bankruptcy Code, and, while broker-dealers are eligible to be liquidated under chapter 7 of the Bankruptcy Code, the resolution of larger broker-dealers has typically proceeded under the supervision of a trustee selected by the Securities Investor Protection Corporation ("SIPC") in proceedings under the Securities Investor Protection Act (SIPA), in which SIPC plays a major ongoing role.

Since the financial crisis that began in 2008, many countries, including the United States, have enacted "special resolution regimes" that give financial regulators greater control of the resolution of large financial firms, including not only OLA in the United States, but also the Bank Resolution and Recovery Directive in the European Union, and legislation in the United Kingdom, Germany and Japan, among other countries.[2]

[2] For a summary of international legislative developments through late 2014, *see* Financial Stability Board, *Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Report to the G20 on progress in reform of resolution regimes and resolution planning for global systemically important financial institutions (G-SIFIs)* (FSB, 12 November 2014) (the "FSB Progress Report").

Importantly, the new legislation typically includes authority for regulators to supervise the resolution of broker-dealers as well as banks, which, for these foreign countries, is a departure from the state of affairs that existed in 2008, where, for example, local broker-dealers affiliated with Lehman Brothers were placed in ordinary insolvency proceedings supervised by a variety of administrators, liquidators and other controlling persons in many parts of the world.

This global trend of providing national regulators with authority to control not just the resolution of banks, but also the resolution of broker-dealers and other operations of global financial firms has had the beneficial effect of encouraging cross-border coordination and advance planning among regulators for the orderly resolution of such firms, reducing the risk of conflict between the administration of a multi-national SIFI's domestic and foreign components. Through the Financial Stability Board and other official channels, global regulators have developed common approaches to the effective resolution of SIFIs, including such matters as key attributes of effective resolution regimes, requirements for capital and total loss absorbing capacity (TLAC), and bail-in (recapitalization) techniques.[3] Regulators have also coordinated to impose requirements that market practices be changed to enhance resolvability. They have, for example, advocated a protocol (announced prior to the Brisbane G-20 Summit in November 2014) for international recognition by contract of provisions in special resolution regimes that limit termination rights in over-the-counter derivatives contracts.[4] Such termination rights were among the major impediments to the orderly resolution of Lehman Brothers and reportedly a source of tens of billions of dollars of value-erosion in that case.[5] In addition, regulators are coordinating firm-specific resolution planning by forming "Colleges of Regulators" for individual firms. In short, lines of communication are now open and there is increasing alignment in approaches among regulators around the world who will control the resolution of parts of a SIFI in key countries, making it far more likely that a multi-national SIFI can be resolved in a speedy and coordinated manner should it ever become necessary.

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[3] *See* the above cited FSB Progress Report.

[4] This protocol, known as the "ISDA Protocol" has already been subscribed to by eighteen G-SIFIs and adherence to the protocol is expected to be expanded pursuant to regulations expected to be promulgated by regulators in jurisdictions where those firms are based, including the United States. The approach contained in the protocol is also expected to be extended to other types of financial contracts, such as repurchase agreements. *See* http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol (announcement by ISDA that 18 global banks have agreed to adhere to the ISDA Protocol).

[5] One recent source cites estimates for the loss in value to the Lehman Brothers bankruptcy estate from the close-out of the firm's derivatives ranging from $50 to $75 billion. *See* Mark J. Roe and Stephen D. Adams, *Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio*, (April 24, 2015, 32 Yale Journal on Regulation, forthcoming) at http://poseidon01.ssrn.com/delivery.php?ID=676067083085098093122026068120065078034050019023060074029023106088102016030125088099032060018032059046053102106092029017124010126023030041068069029117101029092070078041003091025067082106121078027064002072099004121028075008086065006104007026072&EXT=pdf&TYPE=2

While these developments do not mean that the Bankruptcy Code should not be improved to better address the resolution of SIFIs, the Conference strongly believes that laws in place with regard to a regulator controlled SIFI resolution procedure, like the FDIA and OLA, should continue to be available even if the Bankruptcy Code is amended to better address the resolution of SIFIs. In all circumstances effective resolution of a SIFI will be heavily dependent on the confidence and cooperation of regulators in other countries where the SIFI operates, and the ability of U.S. regulators to assume full control of the resolution process to elicit the cooperation from non-U.S. regulators is an essential insurance policy against systemic risk and potential conflict and dysfunction among the multinational components of a SIFI. Greater control of U.S. regulators over any bankruptcy resolution procedure (as suggested below) and the knowledge that U.S. regulators can, if necessary, invoke regulator-controlled resolution procedures are both essential to obtaining the necessary support and cooperation from non-U.S. regulators for the orderly resolution of the firm.

Regulatory Supervision and Control of the Recapitalized Firm

To benefit from all of the work that has been done to coordinate the resolution of a SIFI in multiple countries and to benefit from regulators' expertise regarding how best to resolve the firm, the Conference also believes that regulators should have a very significant role in any bankruptcy case seeking to resolve a SIFI. The expertise of U.S. regulators, who will be "on site" at the financially distressed firm at the time resolution proceedings are commenced and the need for U.S. regulators to coordinate the firm's resolution with controlling regulators in other countries means heavy involvement by U.S. regulators will be critical if adverse systemic effects from the failure of the SIFI are to be prevented or minimized. Put another way, the ability to elicit cooperation from regulators controlling the resolution of the foreign components of a multinational SIFI will likely be compromised if such regulators believe U.S. regulators will not able to exercise an appropriate level of supervision and control over the U.S. components of the SIFI.

Moreover, bankruptcy courts are not experts in the operations of global financial firms, and after a firm has failed, it is unlikely they will be qualified to exercise necessary supervision over the firm. The firm's primary regulators will, among other things, be in the best position to appoint the controlling manager (whatever the title of the officeholder) and, as under Title II of the Dodd-Frank Act, they should be given the authority to do so.

Finally, unlike normal bankruptcies, where equality of treatment of similarly situated creditors, preservation of going concern value and rehabilitation of the firm are the principal goals, in SIFI resolutions the goal of minimizing systemic risk is the most important goal. Regulators are not only best situated to identify systemic risk, but also in the best position to determine how to balance that risk against other goals. This is not to say that regulators should be given total carte blanche to ignore traditional bankruptcy goals, but they need to be in a position to act expertly, quickly and decisively, taking into account both the interest of stakeholders and the public interest, so an appropriate balance can be struck.

For all of the above reasons, the Conference believes regulators should be afforded significant involvement in and supervision over the ongoing operations of a SIFI being resolved in bankruptcy case.

Filing of a Petition by Regulators

While the Conference believes regulators should have greater involvement in a bankruptcy case regarding a SIFI, the Conference is concerned about granting regulators authority to commence a bankruptcy case against a SIFI. FIBA, for example, provides for the commencement of an involuntary case against a SIFI under proposed subchapter V of chapter 11. It provides for a very truncated (16 hour) period to contest the petition and, if necessary, obtain a ruling on an appeal from the order for relief in the case. While the Conference understands the reasons for the abbreviated process due to the need to implement the recapitalization of the firm over the proverbial "resolution weekend" to provide certainty to markets and counterparties and prevent contagion, the Conference submits it is unrealistic to think that such a compressed process for vetting petitions for involuntary relief will afford an opponent of the petition, be it the SIFI itself or a holder or a claim or interest, any real opportunity to contest the petition or the courts any real opportunity to make an informed and reasoned decision on the merits. The limited time for a hearing on and appeal of the order for relief is unrealistically short.

One alternative considered by the Conference was the possibility of allowing regulators to step into the shoes of the SIFI and file a voluntary bankruptcy petition on its behalf, just as regulators could commence regulator-controlled resolution proceedings under other laws, but the Conference concluded that entirely removing the parties' opportunity to contest the regulator's decision to invoke the bankruptcy process was not a real solution to the lack of a sufficient time to contest the petition. The articulated justification for allowing regulators to act is to prevent the SIFI's management from delaying its own petition if necessary to assure orderly resolution of the firm. However, the Conference believes the authority of regulators to act under existing laws, like OLA, the Federal Deposit Insurance Act and the Securities Investor Protection Act, sufficiently serve this purpose. Consequently, the Conference concluded that regulators should not be provided with authority to commence a bankruptcy case against a SIFI, but instead regulators should retain the threat of proceeding under other laws if the SIFI fails to act.[6]

[6] If limitations were placed on the availability of regulator-controlled resolution procedures, which, as noted above, the Conference opposes, the Conference would favor the ability of a regulator to commence a case by filing a voluntary petition on behalf of the debtor in lieu of commencing an involuntary case. If the provision of FIBA affording regulators the ability to commence involuntary proceedings is nonetheless retained, the Conference believes that judges should be given the longest practicable time period to consider and render a decision on the appropriateness of an involuntary petition, and the Conference believes the requisite 48-hour minimum notice should be given to the Chief Judge of the Circuit in which the bankruptcy judge sits, rather than to the Administrative Office of the U.S. Courts.

Lender-of-Last Resort Liquidity

As suggested in the NBC TPRRA Letter, meeting the liquidity needs of a distressed SIFI is essential to successfully resolving the firm without creating undue systemic risk. The business of a SIFI is "maturity transformation"—taking short term loans from depositors and other stakeholders and turning them into long term investments in the economy, like mortgages and corporate loans. When a financial firm becomes distressed, depositors and customers panic and, rather than risk their savings and investments, they make precipitous withdrawals from the firm. In short, they "run." Unlike the typical debtor, where creditors can be stayed from collecting debts until the reorganization is completed, staying a SIFI's depositors and customers from making withdrawals creates systemic disruption and contagion risk. If the firm is to be reorganized, the firm needs to be recapitalized virtually overnight (i.e., over a "resolution weekend"), and the recapitalized firm has to open up on the next business day with sufficient liquidity to meet withdrawals until the "run" subsides and confidence in the firm is restored. By facilitating the creation of a new, non-bankrupt bank holding company to which the recapitalized bank and broker dealer operations of a debtor bank holding company can be speedily transferred for the benefit of the estate, both FIBA and TPRRA seek to facilitate this type of recapitalization. If, however, the recapitalized firm is forced to sell assets to meet a run, market prices will be further depressed, imposing additional losses on the firm and creating losses at other firms who mark their balance sheets to market. The only way to prevent this type of transmission of balance sheet losses and the resulting contagion is for the recapitalized firm to borrow against its unencumbered assets as necessary to meet the outflows, instead of dumping its assets on the market. Secured lender-of-last-resort lending to fully capitalized banks has long been thought justified for just this reason.[7]

A crucial distinction needs to be made between a government bailout of shareholders and creditors by adding equity capital to an insolvent firm on the one hand, and traditional secured lender-of-last-resort liquidity provided to a recapitalized firm on the other. In the former case, taxpayers absorb the firm's losses. In the latter case, private sector shareholders and creditors absorb the firm's losses, and fully secured loans are made only to a recapitalized firm.

The Conference strongly believes that to be successful, any recapitalization procedure, whether under the Bankruptcy Code or under a special resolution regime like OLA, requires a non-market backstop liquidity source as a bridge for the recapitalized firm until liquidity outflows abate and access to market liquidity returns. For this reason, the Conference opposes provisions (like those in TPRRA) that do not provide for lender-of-last-resort liquidity even after a firm's bank and broker-dealer operations have been recapitalized, and supports instead adding provisions that provide assurance that some form of lender-of-last-resort liquidity will be available, on a fully secured basis, for use in all entities in the SIFI group, including the bank and broker-dealer businesses of the recapitalized firm.

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[7] Bagehot, Walter, *Lombard Street: A Description of the Money Market* (1873). *See also* Bipartisan Policy Center, *Too Big to Fail: The Path to a Solution (May 2013).*

Selection Procedure for Judges

In its review of FIBA, the Conference considered the judicial selection process for the resolution of SIFIs under the Bankruptcy Code. The Conference believes that, for the reasons outlined above, specialized expertise and advance judicial training is required for the judge who would preside over the resolution of a SIFI. Moreover, the Conference believes that bankruptcy judges, who regularly deal with the reorganization of financially distressed firms, are better equipped than federal district judges to deal with insolvencies of financial firms. However, even bankruptcy judges do not share regulators' financial-institution specific expertise, and they would require special training to address resolution of a SIFI.

The Conference accordingly supports the idea that, if special procedures are added to the Bankruptcy Code to facilitate the resolution of SIFIs, expert panels of court of appeals judges and bankruptcy judges should be designated in advance by the Chief Justice to address such cases, as provided in Section 4 of FIBA. The Conference also favors a mechanism for selecting a presiding judge from among the designated judges that is similar to the one included in FIBA (where the chief judge for the court of appeals in the circuit where the case is pending selects the presiding judge). The designation of panels of judges is, of course, best coupled with training to help the designated judges develop the requisite expertise to handle complex SIFI bankruptcies, and the Federal Judicial Center might consider offering regular educational programs and written materials to assist the designated judges in addressing issues likely to arise in such cases.

Conclusion

We hope that these comments are useful if bills are proposed in the 114th Congress seeking to amend the Bankruptcy Code to address SIFI resolution. As noted above, the prior legislative proposals did not address various significant issues and failed to effectively mitigate the risk of cross-border dysfunction and conflict in connection with the resolution of multinational SIFI's. The NBC welcomes the opportunity to review and analyze legislation on this subject introduced in the current Congress and to submit further comments and recommendations, including those addressing the issues not previously covered.

Sincerely,

/s/ Richard Levin

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